

THE COMMON OWNERSHIP TAX STRATEGY

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ABSTRACT

The recent mass shift by American retail investors into index funds has given rise to a modern form of common ownership. Significant stakes in most public companies are now held by a core group of large, diversified institutional investors. In parallel, this rise in common ownership has been accompanied by unprecedented levels of corporate tax avoidance. Recent evidence suggests that under the domination of these powerful shareholders, public companies can reduce their tax liability more aggressively, shirking U.S. tax obligations worth billions of dollars.

This Article offers a novel theory that identifies the direct connection between these two trends. It argues that common ownership facilitates a strategic tax behavior that I term “corporate flooding.” In this strategic maneuver, companies with common ownership-ties opt to simultaneously increase their tax-avoidance behavior. Operating in concert creates a surge in noncompliance, flooding the tax agency with complex cases and rapidly exhausting its limited audit resources. The strategy works by simply reducing the probability of noncompliance being detected and penalized, by sabotaging the agency’s capacity to implement anti-avoidance measures. This outcome—which runs counter to the classical deterrence theory model which assumes that the risk of enforcement increases as noncompliance levels decline—demonstrates how common ownership distorts corporate compliance incentives, changing the way public firms approach legal risks.

Given the social cost of common ownership on this scale—and the resulting systematic compliance distortion—the practice of corporate flooding requires an immediate policy response. This Article therefore proposes a double-taxation sanction regime whereby institutional investors would be penalized along with their portfolio companies for illegitimate tax avoidance. Such a regime would not only help restore the deterrent effect

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but may also incentivize common institutional investors to pay a closer look at the tax practices of their companies.

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INTRODUCTION

Can shifts in the ownership of American (U.S.) corporate equity explain changes in tax compliance? For decades, regulators, scholars, and legal practitioners have assumed that the answer is “no.” The traditional view has remained that corporate tax avoidance¹ is best analyzed through the standard model used to examine personal tax avoidance.² Under such a view, in

1. The terms “tax avoidance,” “tax planning,” “tax noncompliance,” and “tax aggressiveness” are used interchangeably in this Article.

2. See Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323 (1972) (introducing a model for exploring an individual taxpayer’s decision on whether and how much taxes to avoid through deliberate underreporting). The model originally analyzed tax evasion rather than tax avoidance but was later applied to tax avoidance as well. Over the past forty-plus years, the model has been extended to other variables such as the applicable tax rate (see Shlomo Yitzhaki, *A Note on Income Tax Evasion: A Theoretical Analysis*, 3 J. PUB. ECON. 201 (1974)), and other sources of uncertainty have successively been incorporated into it (Alex Raskolnikov, *Probabilistic Compliance*, 34 YALE J. ON REGUL. 491, 493 (2017)).

deciding whether to avoid taxes and, if so, to what extent, a company will weigh the potential tax savings against the probability of being caught and penalized (that is, the enforcement probability) and the likely magnitude of the applicable sanction.³ I argue in this Article that in the ever-changing capital market landscape, where public companies share ownership-ties, the traditional analysis of the determinants of corporate tax avoidance is deficient.

To understand why “common ownership”—the overlapping ownership of public companies among large institutional investors—affects the analysis of corporate tax avoidance, one must consider the fact that the U.S. tax agency,⁴ like other regulatory agencies, faces shrinking budgets and limited enforcement resources. Thus, as the agency cannot audit all taxpayers, it must decide how to allocate its collection efforts intelligently.⁵ Logically, collection resources that are exhausted in one tax audit are no longer available for audits of other taxpayers. Hence, in the context of corporate tax avoidance, a specific company’s enforcement probability is dependent not only on its own tax behavior but also on that of other companies as well. This, in turn, creates an inherent interdependence between the enforcement probabilities of different taxpayers that becomes particularly significant when the same investors own multiple companies. The concern I raise in this Article is that these companies, which are now tightly bound together through common ownership links, are knowingly concerting their tax-avoidance levels to take advantage of the agency’s limited audit capacity, thus overwhelming it.

Corporate tax avoidance can be broadly described as a behavior that violates the spirit of the law and causes an explicit reduction in a firm’s tax burden by exploiting unintended weaknesses in the tax code.⁶ This behavior falls within a legal gray area; the law does not explicitly proscribe the tax-planning position (unlike in the case of tax evasion) but nor does it intend

3. See Joel Slemrod, *Cheating Ourselves: The Economics of Tax Evasion*, 21 J. ECON. PERSPS. 25, 35–36 (2007).

4. For brevity, the terms “tax agency,” “tax authorities,” and “IRS” (referring to the U.S. Internal Revenue Service) are used interchangeably in this Article.

5. See Leandra Lederman & Ted Sichelman, *Enforcement as Substance in Tax Compliance*, 70 WASH. & LEE L. REV. 1679, 1681–82 (2013) (“Of course, enforcing the law is costly. As a result, the government cannot ensure 100% compliance . . . More sophisticated analyses contemplate the benefits of discretionary enforcement, which allows a prosecutor or other enforcer leeway in determining whether conduct that may nominally fall within a law’s ambit actually deserves punishment.”).

6. See Eric C. Chaffee, *Collaboration Theory and Corporate Tax Avoidance*, 76 WASH. & LEE L. REV. 93, 97–98 (2019). Tax avoidance encompasses a wide range of activities. At the more extreme end, it encompasses strategies that include minimization of tax obligations through complex international transactions and structures, such as the utilization of tax havens and transfer pricing manipulation.

to allow it.⁷ In recent years, the magnitude of tax avoidance by U.S. corporations has reached an unprecedented scale, underscoring the far-reaching ramifications of this strategic, coordinated tax behavior.

Many of the largest companies in the country now take full advantage of dubious tax-planning opportunities, reducing U.S. government tax revenues by more than an estimated \$100 billion each year.⁸ For example, over the three-year period from 2018 through 2020, almost forty companies on the S&P 500 stock index paid zero federal income taxes, even though all of them were profitable in each of those years.⁹ Moreover, more than seventy companies on the S&P 500, including profitable giants such as Amazon, Nike, Netflix, and General Motors, paid less than half the statutory corporate income tax rate on an aggregate of over \$400 billion in corporate profits.¹⁰ In fact, the number of publicly held companies that successfully zero-out their federal income taxes has roughly doubled in the last few years.¹¹

The documented surge in corporate tax avoidance has coincided with an increase in common ownership among public companies—itsself a result of a shift in corporate ownership.¹² A core group of large institutional investors

7. *Id.* Tax evasion, as opposed to tax avoidance, refers to “illegal and intentional actions taken by taxpayers to circumvent their legally due tax obligations by underreporting incomes, overstating deductions, exemptions, or credits, failing to file appropriate tax returns, and even engaging in barter.” James Alm & Jay A. Soled, *W(h)ither the Tax Gap?*, 92 WASH. L. REV. 521, 524–25 (2017).

8. Kimberly Clausing, *The Real (and Imagined) Problems with the U.S. Corporate Tax Code*, HARV. BUS. REV. (Dec. 6, 2016), <https://hbr.org/2016/12/the-real-and-imagined-problems-with-the-u-s-corporate-tax-code> [<https://perma.cc/UF6E-VZLZ>]; see also RICHARD MURPHY, TAX JUST. NETWORK, THE COST OF TAX ABUSE: A BRIEFING PAPER ON THE COST OF TAX EVASION WORLDWIDE 2 (2011), <https://www.taxjustice.net/wp-content/uploads/2014/04/Cost-of-Tax-Abuse-TJN-2011.pdf> [<https://perma.cc/23JK-BFRK>] (showing that, in 2011, the Tax Justice Network estimated the lower threshold of tax avoidance at 5.1% of global GDP).

9. MATTHEW GARDNER & STEVE WAMHOFF, INST. ON TAX’N & ECON. POL’Y, CORPORATE TAX AVOIDANCE UNDER THE TAX CUTS AND JOBS ACT 1 (2021), https://itep.sfo2.digitaloceanspaces.com/072921-Corporate-Tax-Avoidance-Under-the-Tax-Cuts-and-Jobs-Act_ITEP.pdf [<https://perma.cc/8G3M-FLYN>].

10. *Id.* at 3–4.

11. See Kathryn Kranhold, *Twice as Many Companies Paying Zero Taxes Under Trump Tax Plan*, NBC NEWS (Apr. 11, 2019, 5:00 AM), <https://www.nbcnews.com/business/taxes/twice-many-companies-paying-zero-taxes-under-trump-tax-plan-n993046> [<https://perma.cc/JY3Z-RHZB>]; see also MATTHEW GARDNER, ROBERT S. MCINTYRE & RICHARD PHILLIPS, INST. ON TAX’N & ECON. POL’Y, THE 35 PERCENT CORPORATE TAX MYTH 1 (2017), <https://itep.org/wp-content/uploads/35percentfullreport.pdf> [<https://perma.cc/LD6S-Z555>]. According to the data presented in this report, between 2008 and 2015, 258 Fortune 500 companies were consistently profitable. Of these, 100 paid zero or less in deferral income tax in at least one of these years. Eighteen of them, including General Electric, Priceline.com, and PG&E, did not pay any federal income tax at all throughout this eight-year period. *Id.*

12. The rise in common ownership is primarily attributed to the growing popularity of index investing. According to the Bank for International Settlements, “passive funds managed about . . . 20% of aggregate investment fund assets as of June 2017, up from 8% a decade earlier,” and they account for “43% of total [U.S.] equity fund assets.” Vladyslav Sushko & Grant Turner, *The Implications of Passive*

that oversee mostly passive funds—index funds and exchange-traded funds (ETFs) that track benchmark indices—now owns significant equity stakes in many companies. In 2021, for example, index funds and ETFs owned approximately 16% of the entire U.S. stock market, up from 8% in 2011.¹³ The “Big Three” asset management institutions—BlackRock Group, State Street Global Advisors, and the Vanguard Group—are collectively the “single” largest shareholder in 40% of listed companies in the United States and nearly 90% of the companies on the S&P 500.¹⁴ In 2018, each of these three had at least a 5% equity stake in 2,367 public companies, 2,051 public companies, and 183 public companies, respectively.¹⁵

Now, recent empirical data have revealed that the ownership of these broadly diversified institutional investors is specifically linked to corporate tax avoidance.¹⁶ Notably, two empirical studies have utilized the cross-sectional discontinuity in the ownership of quasi-indexers—investment funds that closely replicate broad market indices, thus forming common ownership links among their portfolio companies—to examine the causal impact of these investors on the tax behavior of their portfolio companies. These two studies looked at the cutoff between two popular indices, the Russell 1000 and the Russell 2000, following index reconstitution, and compared the tax-avoidance levels of companies at the bottom of the former with those of companies in the top tier of the latter. Due to the value-weighted nature of the indices, which gives more weight to companies at the top of an index, companies at the top of the Russell 2000 index have significantly higher levels of quasi-indexer ownership¹⁷ and, accordingly,

Investing for Securities Markets, BIS Q. REV. 113, 114–15 (2018). A recent empirical study found that the average “passive common ownership” measure is approximately twice the “active common ownership” measure, supporting the idea that common ownership is currently on the rise due to an unprecedented increase in index investing. Erik P. Gilje, Todd A. Gormley & Doron Levit, *The Rise of Common Ownership* 24 (June 6, 2017) (unpublished manuscript) (on file with author).

13. INV. CO. INST., 2022 INVESTMENT COMPANY FACT BOOK 30 (2022), https://www.ici.org/system/files/2022-05/2022_factbook.pdf [<https://perma.cc/8XRG-L63H>].

14. Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 313 (2017).

15. Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2099 (2019). While the flooding theory introduced in this Article potentially applies to all large investors with broadly diversified portfolios and not only to passive funds, it focuses on the latter because they now wield disproportionate power over hundreds (if not thousands) of companies and are likely to affect the tax behavior of their portfolio companies.

16. Shuping Chen, Ying Huang, Ningzhong Li & Terry Shevlin, *How Does Quasi-Indexer Ownership Affect Corporate Tax-Planning?*, 67 J. ACCT. & ECON. 278 (2019); Mozaffar Khan, Suraj Srinivasan & Liang Tan, *Institutional Ownership and Corporate Tax Avoidance: New Evidence*, 92 ACCT. REV. 101, 118 (2017).

17. See, e.g., Chen et al., *supra* note 16, at 284 (finding that firms on the top of the Russell 2000 have 13.2% significantly larger quasi-indexer ownership than firms at the bottom of the Russell 1000).

common ownership levels,¹⁸ than those of companies at the bottom of the Russell 1000 index.

Both studies found that two measures commonly used to estimate a firm's level of tax avoidance—GAAP Effective Tax Rates (GAAP ETRs) and Cash Effective Tax Rates (Cash ETRs)¹⁹—are significantly lower among companies at the top of the Russell 2000.²⁰ In fact, the effect that these broadly diversified shareholders have on corporate tax avoidance equates to millions of dollars per year in unpaid taxes for the average company in the sample.²¹ These alarming numbers suggest that as common institutional owners accumulate shares in the public market, companies are increasingly reducing their tax liability using aggressive tax planning.

Against this backdrop, I argue that the positive correlation between common ownership and corporate tax avoidance reflects a fundamental compliance distortion that ensues when the same influential investors own a large proportion of the market between them. This distortion, which has been overlooked in the extant literature, can be attributed to a strategic tax behavior—identified for the first time in this Article—that I term “corporate flooding.”²² In this maneuver, multiple public companies, all under the direction of a core group of common institutional shareholders, act collectively to simultaneously adopt more aggressive tax positions (and more positions on their tax returns overall). This across-the-board surge in instances of public-company tax noncompliance inundates the tax agency with complex cases, which, as noted earlier, renders it logistically harder for the agency to implement anti-avoidance measures as its resources become increasingly overstretched.

Given the IRS's limited (and dwindling) enforcement resources²³ and its organizational structure—in which all public corporations' filings are

18. See, e.g., Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111, 119 (2016) (“On average, the ownership stake of each of [the Big Three] is a third higher for the 250 firms at the top of the Russell 2000 relative to the bottom 250 firms of the Russell 1000, while the likelihood of each institution owning more than 5% of a firm's shares is two-thirds higher and the likelihood of being a top five shareholder is 15% higher.”).

19. GAAP ETR refers to the total tax expenses paid per dollar of book income, while Cash ETR refers to the cash taxes paid per dollar of book income. It is important to note that although public companies are not mandated to disclose their ETRs, some companies may choose to disclose them in their investor presentations, corporate sustainability reports, or other voluntary disclosures. Alternatively, ETRs can be calculated by analyzing tax-related information contained in a company's financial statements, such as the income tax provision and the actual tax expense incurred.

20. See *infra* notes 121–22 and accompanying text.

21. See *infra* note 126 and accompanying text.

22. The terms “flooding” and “corporate flooding” are used interchangeably in this Article.

23. Several sources address the continuing shortfall in the IRS's resources and personnel. See Natasha Sarin & Lawrence H. Summers, *Shrinking the Tax Gap: Approaches and Revenue Potential* (Nat'l Bureau of Econ. Rsch., Working Paper No. 26475, 2019), <https://www.nber.org/papers/w26475.pdf> [<https://perma.cc/MJ5J-9MNP>] (presenting data regarding the decline in the IRS budget,

reviewed by a single division²⁴—when faced with a large, synchronized avoidance effort, this embattled division is quickly swamped with an ever-rising number of noncompliant returns. Under these circumstances, the effectiveness of at least one of the audit stages (audit selection, case development, or deficiency collection) is likely to be compromised,²⁵ which reduces the probability of future enforcement, thereby activating the cyclical “flooding effect.”

I contend that the flooding effect has significant adverse consequences because it reverses the traditional correlation between compliance and enforcement that is necessary for the tax system’s proper functioning.²⁶ Usually, higher levels of tax avoidance are associated with a greater probability of enforcement as the agency tends to allocate more of its limited resources to taxpayers that appear to be more tax-aggressive.²⁷ However, flooding occurs when higher levels of tax avoidance are simultaneously adopted by more companies than the “norm,” and this, I argue, actually leads to the opposite outcome. Here, I show how, by reducing enforcement probability, flooding can increase public companies’ optimal level of tax avoidance.²⁸ With the threat of enforcement thus reduced, and knowing they are much less likely to be penalized if they continue to act in concert, companies are more inclined to seek higher tax-avoidance levels. My underlying contention, then, is that corporate flooding is a self-perpetuating process that relies on the dynamic created by collective action, which results in a new noncompliance equilibrium.

particularly the enforcement budget, over the past years); Aaron Grey, *IRS Developments and Examination Strategies*, 5 CONTEMP. TAX J. 45 (2016); John A. Koskinen, *The Challenges Facing the IRS of the Future*, 45 OHIO N.U. L. REV. 561 (2019); see also *Nearly Half of Corporate Giants Escape IRS Audit in 2017*, TRAC IRS (Apr. 9, 2018), <https://trac.syr.edu/tracirs/latest/507/> [<https://perma.cc/6B8F-8AMU>] (“Congressional cutbacks to IRS’s budget have severely trimmed the ranks of available IRS revenue agents - the auditors who examine corporate and high income individual returns. Last year, there were 5,144 fewer IRS revenue agents employed than there had been in FY 2010. Over the past seven years, revenue agents have fallen by over a third (34.9%). Fewer auditors mean that fewer audits can be conducted.”).

24. See *infra* note 81 and accompanying text.

25. Enforcement probability can be divided into three components: the probability of detection, the probability of enforcement action, and the probability of liability. See Keith N. Hylton & Haizhen Lin, *Optimal Antitrust Enforcement, Dynamic Competition, and Changing Economic Conditions*, 77 ANTITRUST L.J. 247, 254 (2010) (discussing the definition of enforcement probability in the antitrust context). The probability of liability signifies the likelihood that the tax authorities will challenge a tax position (in this Article, case development) and collect all the tax due, plus interest, plus penalties (in this Article, deficiencies collection). See David Ulph, *Avoidance Policies – A New Conceptual Framework* (Oxford Univ. Ctr. for Bus. Tax’n, Working Paper No. WP 09/22, 2009), <https://core.ac.uk/download/pdf/74367229.pdf> [<https://perma.cc/SXK7-NEQU>].

26. See *infra* Section I.B.

27. See *infra* note 48 and accompanying text.

28. For a more comprehensive discussion on a company’s optimal level of tax avoidance, see Jaewoo Kim, Sean T. McGuire, Steven Savoy & Ryan Wilson, *How Quickly Do Firms Adjust to Optimal Levels of Tax Avoidance?*, 36 CONTEMP. ACCT. RSCH. 1824 (2019).

I hold that common institutional owners are the driving force behind the flooding strategy and identify here the role of these dominant market players in facilitating flooding. Because powerful institutional investors now hold substantial stakes in myriad companies, they can wield their influence to affect those companies' tax behavior. Thus, these highly diversified shareholders have the capacity to induce a sufficiently large number of corporations to pursue greater tax avoidance.²⁹ This observation is important because it is only when enough companies participate in flooding that adopting higher tax-avoidance levels becomes a profitable choice. In other words, aggressive tax behavior may not pay off unless the IRS is sufficiently overwhelmed not to pursue audits or successfully combat aggressive tax behavior.

As I will show, several causal mechanisms can connect common ownership to higher tax-avoidance levels, some of which do not entail direct communication between institutional investors and their portfolio companies.³⁰ The ability to link tax savings to financial profitability, for example, demonstrates how flooding can be triggered at a relatively low cost. Simply increasing pressure on senior management to deliver high earnings can lead to more aggressive tax behavior. Indeed, in light of ample empirical evidence that long-term institutional shareholding is positively associated with a firm's performance and rate of return,³¹ such a scenario seems highly plausible. Other causal mechanisms that potentially link common ownership and corporate tax avoidance, such as direct engagement with management and the effect on board composition, are also explored here. These various mechanisms illustrate how even characteristically passive institutional investors that have a relatively weak incentive to invest in stewardship can lead to an across-the-board increase in tax avoidance with no need to invest heavily in resources or acquire firm-specific knowledge.

In identifying the corporate flooding strategy and describing how common ownership distorts corporate compliance incentives, this Article makes four novel contributions to the literature on the role of common institutional investors in corporate conduct, generally, and tax avoidance, specifically. First, it demonstrates that, when institutional investors "own it all," they can mitigate firm-specific (so-called idiosyncratic) risks—specifically, enforcement risks—that public companies may face. Modern portfolio theory contends that, because diversification reduces risk at every level of expected return, fully diversified investors in capital markets can

29. See *infra* Part I.

30. See *infra* Part II.

31. See, e.g., Appel et al., *supra* note 18; Jarrad Harford, Ambrus Keeskés & Sattar Mansi, *Do Long-Term Investors Improve Corporate Decision Making?*, 50 J. CORP. FIN. 424, 426, 442 (2018).

smooth out idiosyncratic fluctuations in their portfolios and improve risk-adjusted returns.³² The corporate flooding strategy, however, illustrates that diversification reduces the idiosyncratic risk not only at the portfolio level but also at the individual company level, incentivizing companies to assume more noncompliance risks. This is a crucial observation with far-reaching implications for twenty-first-century corporate conduct. As common ownership continues to dominate the market, companies are likely to face lower idiosyncratic risks associated with corporate misconduct.

Second, I reveal here an overlooked pathway through which concentration in the U.S. capital markets harms the economy. Flooding exacerbates the tax agency's difficulties in regulating tax avoidance, allowing public companies to improperly avoid paying their fair dues. And this, in turn, has adverse implications for fiscal policy. When governments are deprived of tax revenues, they must choose the lesser evil between rising deficits, lowering spending on the common good, or increasing taxes to compensate for this lost income, which will shift the tax burden to other, compliant, taxpayers.³³ These ramifications also demonstrate the correlation between tax avoidance and inequality—which is now acknowledged by a growing body of literature³⁴—potentially linking corporate tax avoidance to the broader, pressing issue of corporate social responsibility.³⁵

Another aspect of the corporate flooding strategy that ties this practice to inequality is the fact that the asset management industry represents relatively high-income investors.³⁶ This suggests that wealthy individuals are the ones who benefit most from public companies' amplified earnings.

32. See, e.g., Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77, 89 (1952).

33. Natasha Sarin, *The Case for a Robust Attack on the Tax Gap*, U.S. DEP'T TREASURY (Sept. 7, 2021), <https://home.treasury.gov/news/featured-stories/the-case-for-a-robust-attack-on-the-tax-gap> [<https://perma.cc/79NY-GBLP>].

34. See, e.g., Emmanuel Saez & Gabriel Zucman, *Wealth Inequality in the United States Since 1913: Evidence from Capitalized Income Tax Data* (Nat'l Bureau of Econ. Rsch., Working Paper No. 20625, 2014), <https://www.nber.org/papers/w20625> [<https://perma.cc/HSZ5-ZV7M>]; Annette Alstadsæter, Niels Johannesen & Gabriel Zucman, *Tax Evasion and Inequality* (Nat'l Bureau of Econ. Rsch., Working Paper No. 23772, 2017), <https://www.nber.org/papers/w23772> [<https://perma.cc/RYSV-8FE8>]; Frederik Heitmüller, Moran Harari & Markus Meinzer, *Tax Administrations' Capacity in Preventing Tax Evasion and Tax Avoidance* (Oct. 17, 2018) (unpublished manuscript), <https://ssrn.com/abstract=3300589> [<https://perma.cc/Z3SZ-F9CM>]; Ute Schmiel & Anna-Lena Scherer, *Inequality and Taxation of Multinational Corporate Groups* (Copenhagen Bus. Sch., Law Rsch. Paper Series No. 20-19, 2020), <https://ssrn.com/abstract=3678145> [<https://perma.cc/GUN3-ZQXT>].

35. See, e.g., Grahame R. Dowling, *The Curious Case of Corporate Tax Avoidance: Is It Socially Irresponsible?*, 124 J. BUS. ETHICS 173, 179 (2014) (arguing that non-payment of taxes shifts the tax burden to other and less mobile taxpayers, thereby increasing inequalities).

36. See, e.g., Edward N. Wolff, *Household Wealth Trends in the United States, 1962 to 2016: Has Middle Class Wealth Recovered?* 34 (Nat'l Bureau of Econ. Rsch., Working Paper No. 24085, 2017), <https://www.nber.org/papers/w24085> [<https://perma.cc/2VQT-J8KN>] (showing that, in 2016, the top 10% of American households owned 84% of all stocks, and that, while 94% of the wealthiest people in the United States have significant stakes in publicly held companies—\$10,000 or more—only 27% of the middle class hold such stakes).

The costs of tax avoidance, on the other hand, are borne disproportionately by lower-income individuals in their role as citizens consuming public services. The potential distributional implications of common ownership are, therefore, profound.

Third, in analyzing the flooding strategy and the role of institutional investors in facilitating this phenomenon, this Article draws on the new type of agency-costs problem associated with the rise of financial intermediaries—the “agency costs of agency capitalism”—which was first identified by Ronald Gilson and Jeffery Gordon a decade ago.³⁷ According to Gilson and Gordon’s theory, in intermediated markets, where institutional investors serve as intermediaries between shareholders (the ultimate owners) and the corporation, a new set of agency costs arises due to divergence between the interests of such shareholders and those of their institutional agents. This Article offers a new perspective on the agency capitalism problem by arguing that the actions of the institutional investors may not align with the political preferences of the beneficial owners of the shares.

Specifically, although the beneficiaries may benefit from a company’s lower tax payments through higher portfolio returns, those same beneficiaries might hold social or political preferences besides profit maximization. For example, they may prefer companies to pay their fair share of taxes.³⁸ The welfare of beneficiaries, however, can only be maximized if those preferences are also considered. Unfortunately, the detrimental effect of large institutional investors on corporate tax compliance suggests that the social and political preferences of many beneficial owners are often disregarded.³⁹

Finally, to address the concerns outlined in this Article, I present a proposal for a novel policy reform in the form of a double-taxation sanction

37. See Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 889–95 (2013).

38. See, e.g., Iftekhar Hasan, Chun-Keung Hoi, Qiang Wu & Hao Zhang, *Does Social Capital Matter in Corporate Decisions? Evidence from Corporate Tax Avoidance*, 55 J. ACCT. RSCH. 629, 630 n.1 (2017) (arguing that there is a widely shared societal belief that all citizens and corporations hold a civic duty to pay taxes, referring to an annual Taxpayer Attitude Survey which reported that more than 90% of the taxpayers surveyed either completely or mostly agreed that “it is every American’s civic duty to pay his or her fair share of taxes” (citation omitted)).

39. Compare Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L. FIN. & ACCT. 247, 251 (2017), with Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 740 (2005). A somewhat similar concern was also voiced in the context of tax avoidance by Professor Ilan Benshalom. Ilan Benshalom, *Who Should Decide Whether the Apple Is Rotten? Tax Disclosure and Corporate Political Agency*, 6 COLUM. J. TAX L. 86 (2014). In his article, Benshalom claims that the ownership structure of publicly held companies might give rise to what he calls a “political agency problem” because managers, maximizing value for their shareholders, tend to overlook the political preferences of those shareholders. *Id.* at 89.

regime.⁴⁰ Under such a dual system, not only would the tax-avoiding company be penalized for any illegitimate tax-avoidance behavior but also its institutional shareholders. Such a regime would enable the tax authority to recover from both parties without having to invest more of its scarce resources. More importantly, the proposed system could act as a deterrent and break the flooding cycle by providing an incentive for institutional shareholders to push for more tax compliance. Even if the portfolio companies' heightened engagement in tax avoidance is only a by-product of the institutional investors' demands for better financial performance, the regime I propose might cause them to pay closer attention to their companies' tax policies. And this, in turn, could help restore the deterrent effect, reinstate fairness, and help alleviate wealth inequality.

This Article proceeds as follows. Part I explains the corporate flooding strategy and its detrimental effect on tax enforcement. This Part also presents empirical support for the theory that common institutional ownership leads to increased corporate tax avoidance. Part II identifies some of the potential causal mechanisms through which common ownership promotes flooding, none of which requires collusion or active coordination between institutional investors and corporate managers or between managers of portfolio companies. Part III proposes an innovative policy reform to curb corporate flooding and analyzes the potential utility of the recommendation.

I. INTRODUCING THE "CORPORATE FLOODING" TAX STRATEGY

Since the beginning of the twenty-first century, a massive capital shift toward asset management institutions has given rise to a new ownership pattern in the U.S. capital markets: common ownership. This emerging trend has several interesting implications for corporate behavior, governance, and market outcomes, which are now being intensely investigated.⁴¹ In this Part, I analyze the tax-avoidance repercussions of this ownership structure by explaining what I term "corporate flooding."

40. See *infra* Part III.

41. To date, the research on common ownership has mainly focused on the product-market behavior of rival firms with common ownership links. See, e.g., José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018) [hereinafter Azar et al., *Anticompetitive Common Ownership*]; José Azar, Sahil Raina & Martin Schmalz, *Ultimate Ownership and Bank Competition*, 51 FIN. MGMT. 227 (2022) [hereinafter Azar et al., *Bank Competition*]. Moreover, scholars have recently explored the effect of common ownership on the labor market, Zohar Goshen & Doron Levit, *Irrelevance of Governance Structure* (Eur. Corp. Governance Inst., Fin. Working Paper No. 606/2019, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3340912 [https://perma.cc/VA5R-2YTC], environmental compliance, Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1 (2020), investment in Research and Development (R&D), Miguel

A. Framework for Analysis

Traditionally, tax law literature has analyzed corporate tax avoidance through the standard lens of individual choice.⁴² According to this approach—essentially, a deterrence model—a corporate taxpayer will choose whether to attempt to avoid taxation in the same way a person approaches any risk-related decision.⁴³ In deciding whether to avoid paying taxes and, if so, to what degree, the taxpayer compares the potential tax savings against the enforcement probability and the expected magnitude of the correlating sanction.⁴⁴ When companies apply this model, they generate a target level of tax avoidance that maximizes their value.⁴⁵

Traditionally, enforcement probability has generally depended on two principal factors. The first is the tax agency's enforcement capacity. As the IRS has finite resources, it can only audit a fraction of all taxpayers, allowing some noncompliant taxpayers to escape scrutiny.⁴⁶ The capacity of the agency therefore impacts the taxpayer's tax-planning decisions: the greater the enforcement resources, the greater the discouragement of tax-avoidance behavior.⁴⁷

Antón, Florian Ederer, Mireia Giné & Martin Schmalz, *Innovation: The Bright Side of Common Ownership?* (May 25, 2021) (unpublished manuscript), <https://ssrn.com/abstract=3099578> [<https://perma.cc/BU8B-YDJY>], and disclosure practices, Jihwon Park, Jalal Sani, Nemit Shroff & Hal White, *Disclosure Incentives When Competing Firms Have Common Ownership*, 67 J. ACCT. & ECON. 387 (2019).

42. See *supra* note 2. When dealing with individuals' tax-avoidance choices, the tax literature also analyzed the intrinsic motivation of taxpayers to comply with tax liabilities because of civic duty. See Bruno S. Frey, *A Constitution for Knaves Crowds Out Civic Virtues*, 107 ECON. J. 1043, 1050 (1997). A young but growing literature has recognized the unique characteristics of corporate tax avoidance, which is mainly attributed to the separation of ownership and control in a corporation. See Keith J. Crocker & Joel Slemrod, *Corporate Tax Evasion with Agency Costs*, 89 J. PUB. ECON. 1593, 1596 (2005); Christopher S. Armstrong, Jennifer L. Blouin, Alan D. Jagolinzer & David F. Larcker, *Corporate Governance, Incentives, and Tax Avoidance*, 60 J. ACCT. & ECON. 1, 2 (2015). This separation requires corporate tax avoidance to be explored somewhat differently. In particular, tax-law literature has recognized the need to incorporate agency predictions into the analysis of corporate tax avoidance and take into account potential agency costs.

43. See Slemrod, *supra* note 3.

44. *Id.*

45. See *supra* note 28 and accompanying text.

46. See Lederman & Sichelman, *supra* note 5, at 1688; see also Michelle Nessa, Casey Schwab, Bridget Stomberg & Erin Towery, *How Do IRS Resources Affect the Tax Enforcement Process?*, in PROCEEDINGS ON TAXATION AND MINUTES OF THE ANNUAL MEETING OF THE NATIONAL TAX ASSOCIATION (2016) (providing more nuanced evidence on how the IRS prioritizes its audit efforts when faced with limited resources during each audit stage).

47. See Jeffrey L. Hoopes, Devan Mescall & Jeffrey A. Pittman, *Do IRS Audits Deter Corporate Tax Avoidance?*, 87 ACCT. REV. 1603 (2012). However, the magnitude of such a deterrent effect is not clear. See Lederman & Sichelman, *supra* note 5, at 1682; Joel Slemrod, *Tax Compliance and Enforcement* 12 (Nat'l Bureau of Econ. Rsch., Working Paper No. 24799, 2018), <https://www.nber.org/papers/w24799> [<https://perma.cc/7AJC-VWJ4>] ("When explicit enforcement is weak (e.g., few audits), legitimacy may erode, undermining the intrinsic willingness of taxpayers to comply with the law.").

The second factor that affects enforcement probability is the taxpayer's compliance level. The traditional model applied to predict individuals' tax-avoidance choices assumes that there is an intrinsic positive correlation between suspected noncompliance and enforcement probability. In other words, the model assumes that part of the IRS's decision to audit is based on a suspected level of tax risk and avoidance.⁴⁸ Thus, the probability of enforcement normally increases as the level of tax-avoidance aggressiveness rises.⁴⁹ The correlation between noncompliance and enforcement probability is generally believed to serve as a deterrent mechanism that is desirable from a public policy perspective. The premise here is that taxpayers would be so wary of audits that they would forego tax-avoidance opportunities, even at the cost of paying more taxes.⁵⁰

But what if there is another factor that affects enforcement probability? In the "corporate flooding" strategy, which is specifically tied to common ownership by institutional investors, the participant companies simultaneously increase the number of aggressive filings, thus complicating the traditional tax-avoidance model.

B. Spotting the "Corporate Flooding" Tax Strategy

The U.S. stock market landscape has changed dramatically over the past decade. Investors in capital markets have flocked to investment funds, particularly index funds, enabling institutional investors to become much larger at the expense of retail investors and also exceptionally concentrated. This market shift has resulted in a situation where institutional investors currently account for unprecedented levels of stock ownership in public companies. In fact, institutional investors now collectively own between 70

48. See, e.g., Slemrod, *supra* note 3, at 35–38; Nessa et al., *supra* note 46, at 6; see also James Alm & Michael McKee, *Tax Compliance as a Coordination Game*, 54 J. ECON. BEHAV. & ORG. 297, 298 (2004) (discussing "audit flags" and how they are utilized by the IRS to select returns for audits).

49. Alm & McKee, *supra* note 48, at 298–99 (discussing the variability and endogeneity of audit probability, depending on the behavior of a taxpayer); see also Michael J. Graetz, Jennifer F. Reinganum & Louis L. Wilde, *The Tax Compliance Game: Toward an Interactive Theory of Law Enforcement*, 2 J.L. ECON. & ORG. 1, 5–6 (1986) (explaining that the IRS adjusts its audit and enforcement strategy in light of the information contained in a taxpayer's tax return); Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 571 (2006) (claiming that the probability of detection varies among different items on a tax return). On the IRS's techniques to gauge higher levels of tax avoidance, see *infra* Section I.C.1.

50. Raskolnikov, *supra* note 49, at 593–94 (explaining that many taxpayers look for avoidance opportunities with the lowest probability of detection).

and 80% of the entire stock market,⁵¹ representing shares worth over \$22 trillion.⁵² This compares to less than 25% during the 1980s.⁵³

Among institutional investors, mutual funds, in particular, have experienced a marked increase in market share and position sizes due to the extraordinary growth and popularity of investment funds,⁵⁴ which can offer low-cost diversification and favorable tax treatment to retirement savers.⁵⁵ Index funds, a subset of mutual funds that track market indices, now hold nearly 50% of all U.S. listed companies.⁵⁶ The Big Three asset managers, which are mainly known for their broad market index funds, have gained enormous popularity over the past decade.⁵⁷ In 2022, the Big Three oversaw assets worth over \$22 trillion, the equivalent of more than half of the combined value of all companies on the S&P 500.⁵⁸ At least one of those institutions was the largest shareholder in 88% of the companies in the S&P 500 stock index.⁵⁹

The growing presence of institutional investors in capital markets was initially welcomed with enthusiasm.⁶⁰ Scholars predicted that, because such investors are sophisticated and well-resourced, they would make informed use of their voting rights and potentially improve firm value.⁶¹ Moreover, given such investors' tendency to support strong corporate governance, some legal observers assumed that institutional ownership would likely

51. Azar et al., *Anticompetitive Common Ownership*, *supra* note 41, at 1514.

52. See Bd. of Governors of the Fed. Rsr. Sys., *Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts* 130 (2021), <https://www.federalreserve.gov/releases/z1/20210610/z1.pdf> [<https://perma.cc/RH8W-PFAQ>].

53. See Azar et al., *Anticompetitive Common Ownership*, *supra* note 41, at 1514.

54. See, e.g., Zohar Goshen & Sharon Hanes, *The Death of Corporate Law*, 94 N.Y.U. L. REV. 263, 304–06 (2019) (discussing the changes in the division of the three main groups of institutional investors: mutual funds, pension funds, and insurance companies). For a general discussion on the growth of mutual funds, see MATTHEW P. FINK, *THE RISE OF MUTUAL FUNDS: AN INSIDER'S VIEW* (1st ed. 2008).

55. See Goshen & Hanes, *supra* note 54, at 35–36.

56. See Jeff Cox, *Passive Investing Automatically Tracking Indexes Now Controls Nearly Half the US Stock Market*, CNBC (Mar. 19, 2019, 5:56 PM), <https://www.cnbc.com/2019/03/19/passive-investing-now-controls-nearly-half-the-us-stock-market.html> [<https://perma.cc/AV3D-MPWG>].

57. See Fichtner et al., *supra* note 14, at 313.

58. Farhad Manjoo, *What BlackRock, Vanguard and State Street Are Doing to the Economy*, N.Y. TIMES (May 12, 2022), <https://www.nytimes.com/2022/05/12/opinion/vanguard-power-blackrock-state-street.html> [<https://perma.cc/6HFF-ZSNR>].

59. Fichtner et al., *supra* note 14, at 313.

60. See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992) (arguing that large institutional investors can help overcome the collective-action problem of shareholders and effectively monitor corporate managers); Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994) (envisioning a scenario where institutional investors cooperate with each other to institute cumulative voting and campaign with management for charter amendments).

61. See, e.g., OECD, *THE ROLE OF INSTITUTIONAL INVESTORS IN PROMOTING GOOD CORPORATE GOVERNANCE* (2011), <http://www.oecd.org/daf/ca/49081553.pdf> [<https://perma.cc/G36Z-C5CT>].

empower shareholders and constrain managerial agency costs.⁶² As a result, policymakers and legal scholars believed that the shift toward greater institutional ownership reflected a positive progression in capital markets.⁶³

The reality, however, deviates considerably from this benign ideal. According to the emerging literature, market distortions ensue under institutional ownership, particularly when the same institutional investors have overlapping ownership in multiple companies.⁶⁴ This “common ownership” pattern has become especially prevalent as institutional ownership and index investing have expanded.⁶⁵ Common owners are characterized by two main features that, when considered together, are somewhat counterintuitive. On the one hand, common institutional investors hold shares in hundreds, if not thousands, of companies and, thus, their portfolios are extremely diversified.⁶⁶ On the other hand, because they hold sizable stakes in many of their portfolio companies, they are often the largest shareholders.⁶⁷ Thus, common owners are also concentrated shareholders.

In light of the unique characteristics of common owners, commentators have recently hypothesized that this ownership has negative implications for both markets and society. The primary concern is that, given their sizable stakes in many companies and their growing involvement in the governance of their portfolio companies, common institutional owners will wield their influence to promote socially undesirable corporate conduct.⁶⁸ The present

62. Black, *supra* note 60; Gordon, *supra* note 60.

63. In fact, the concern among corporate law scholars is often that institutional investors might lack the capacity and incentive to become adequately involved in the governance of their companies. These scholars have proposed potential market institutions and policy shifts that would improve institutional investors’ engagement in stewardship. *See, e.g.*, Gilson & Gordon, *supra* note 37, at 889 (“Mutual funds and other for-profit investment managers are almost uniformly reticent . . .”); Bebchuk & Hirst, *supra* note 15, at 2099 (explaining why passive fund managers have strong incentives to underinvest in stewardship and defer to the preferences of corporate managers).

64. *See, e.g.*, Azar et al., *Anticompetitive Common Ownership*, *supra* note 41; Azar et al., *Bank Competition*, *supra* note 41. Both studies provide empirical evidence showing that common ownership of rival firms affects the product–market behavior of such firms and leads to price increases. *See also* Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016) (laying out a theoretical foundation for the anticompetitive common ownership theory); Goshen & Levit, *supra* note 41 (showing that common ownership increases the number of firms with strong governance above the competitive allocation and deters investment by corporate managers in value-creating projects).

65. *See supra* note 12 and accompanying text. Depending on the measure used, common ownership expanded by 1,600% to 2,300% from 1980 to 2012. *See* Gilje et al., *supra* note 12, at 4. During the 1980s, a typical pair of firms had 1.7 owners in common, but by 2012 this figure had increased to 33.6. *See id.* at 25.

66. On average, the largest asset management institutions hold shares in thousands of companies, while retail investors typically have stakes in significantly fewer. *See* Fichtner et al., *supra* note 14, at 299.

67. *Id.* at 311–12, 312 tbl.2 (explaining that institutional investors tend to own exceptionally high equity stakes in the largest companies); Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89, 92 tbl.1. (2017).

68. *See supra* note 64 and accompanying text.

study supplements that literature by exposing the extensive role that common institutional owners play in distorting the tax compliance incentives of corporate decision-makers.

Recent empirical studies show that institutional ownership, particularly by quasi-indexer shareholders that are more likely to be common institutional owners,⁶⁹ is linked to an increase in the levels of tax avoidance adopted by the portfolio companies.⁷⁰ As the ownership of these institutions in U.S. corporations increases, a larger number of companies engage in tax avoidance, an increased number of tax positions are adopted, and more questionable tax-avoidance positions are embraced. When coordinated on a large scale, as we have seen, it is the simultaneous increase in tax-avoidance behavior among multiple public companies sharing ownership links that constitutes what I term “corporate flooding.” My underlying theory about flooding, then, is that it is essentially a numbers game.

Normally, the IRS’s decision to audit a taxpayer is based on its assessment of the likelihood that underreporting will, indeed, be detected (as well as the likely scale of the resources required to undertake the endeavor).⁷¹ As explained earlier, higher levels of tax noncompliance entail a greater likelihood that the company will be audited. Since companies take enforcement probability into account when choosing whether to avoid taxes (and to what degree), the level they ultimately adopt is assumed to optimize the aggressiveness of the tax positions after accounting for the perceived audit risk associated with the tax behavior.⁷² Thus, under the logic of the aforementioned traditional model typically applied to individual taxpayers, increasing tax-avoidance levels beyond an optimal level would be detrimental as it would subject the firm to unnecessary risk.

Under common ownership, on the other hand, higher levels of tax avoidance can actually mitigate tax risk. When myriad companies concurrently file returns with higher tax-avoidance levels, thereby “flooding” the tax agency with aggressive returns, the agency will not have sufficient resources to adequately detect underreporting and effectively audit all aggressive returns. The resulting overload faced by the tax agency, which is empirically linked to institutional ownership, diminishes the effectiveness of tax audits and reduces enforcement probability: fewer companies undergo tax audits, fewer positions are detected and challenged during audits, and smaller deficiencies are collected.⁷³ Thus, in a reversal of

69. On the correlation between quasi-index ownership and common ownership, see sources cited *supra* note 18.

70. See *infra* Section I.D.

71. See *supra* notes 48–49; see also *infra* notes 84–86.

72. See *supra* notes 42–45 and accompanying text.

73. See *infra* Section I.C.

the traditional model, more aggressive tax behavior lowers the chances of being audited and penalized.

Note that the reversal of the traditional model illustrates a critical point: one company's tax behavior can affect the enforcement probability of not just that company but of other companies as well. Therefore, I argue that a core group of institutional investors, each of which holds stakes in multiple corporations, can push for an across-the-board increase in corporate tax avoidance, which would, in turn, diminish enforcement probability. If a sufficient number of companies participate in the flooding strategy, they reduce both their own enforcement probability and that of other commonly owned companies.

The implications of the flooding strategy for twenty-first-century corporate conduct are far-reaching. The change in the profitability of tax avoidance demonstrates that common ownership may affect how public companies approach tax risks (and perhaps legal risks, more generally). According to modern portfolio theory, public shareholders can construct their portfolios in a way that enables them to diversify-away idiosyncratic (firm-specific) risks.⁷⁴ The corporate flooding strategy I theorize here illustrates that diversification can reduce idiosyncratic risks not only at the portfolio level but also at the level of the individual portfolio company. In other words, by facilitating flooding, the new capital market creature—that is, the diversified-yet-concentrated common institutional owner—can cause a reduction in the calculation of a company's expected loss associated with tax-avoidance behavior. This key factor, I argue, suggests that common ownership can lead to escalating levels of noncompliant behavior, augmenting the economic incentive of public companies to adopt socially undesirable actions that previously (pre-flooding) would have been considered too risky or expensive.⁷⁵

Before analyzing the detrimental effect of flooding in each of the tax-audit stages, it is worth considering how the consequences of the flooding theory avoid the critique most often aimed at contemporary anticompetitive common-ownership theory. According to that theory, common ownership influences product markets by causing price coordination between

74. See Markowitz, *supra* note 32. The theory identifies two types of financial risk: economy-wide systematic risk and firm-specific risk. See RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, *PRINCIPLES OF CORPORATE FINANCE* 168–70 (10th ed. 2011) (distinguishing between “unique risk” and “market risk”); Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 200 (2008) (discussing the systematic risks caused by economy-wide variables).

75. *Contra* Asaf Eckstein, *The Virtue of Common Ownership in an Era of Corporate Compliance*, 105 IOWA L. REV. 507, 507 (2020) (claiming that institutional investors that are invested in firms within the same industry have enhanced incentives for monitoring compliance and minimizing “macro legal risks”). This opinion overlooks the fact that the enforcement agencies' resources are limited, so a high level of noncompliance may affect the legal risk itself.

competing commonly owned companies.⁷⁶ Several empirical studies have validated the theory, showing that common ownership is positively correlated with price increases in a particular industry (such as airlines or banking).⁷⁷ Yet, that theory remains hotly debated. Its critics point to the fact that the second-order implications of such price coordination render such behavior unlikely. Because common owners are extremely diversified, the criticism goes, companies in the upstream or downstream chain, as well as in complementary industries, would be adversely impacted by such behavior.⁷⁸ Therefore, common owners with diversified portfolios would have a weak incentive to push for price coordination.⁷⁹

But this criticism does not apply when it comes to the flooding strategy. The negative externalities associated with increased tax-avoidance levels are not inflicted on other companies that are potentially commonly owned but, rather, on the government and society at large. On the contrary, other companies might actually benefit from flooding, as the abnormal levels of avoidance reduce the enforcement probability for other taxpayers. Moreover, the apparent gains associated with “successful” tax avoidance might benefit other commonly owned companies that maintain business relationships with the tax-avoiding companies.⁸⁰ Because flooding is harmless (and perhaps beneficial) to other companies, I contend that it is a strategy that is likely to flourish under common ownership.

C. Flooding's Threat to Tax Enforcement

To better assess the potential adverse effect of a concurrent increase in tax avoidance on enforcement, it is necessary to first understand the division of labor within the IRS and the different stages of the tax audit procedure. Within the IRS, a single division known as the Large Business and International Division (LB&I) is responsible for handling all matters related to corporations (including Subchapter S corporations and partnerships) with assets greater than \$10 million.⁸¹ Over the last decade, this division has

76. See *supra* note 64 and accompanying text.

77. See, e.g., Azar et al., *Anticompetitive Common Ownership*, *supra* note 41; Azar et al., *Bank Competition*, *supra* note 41.

78. C. Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership*, 129 YALE L.J. 1392, 1429–40 (2020); Thomas A. Lambert & Michael E. Sykuta, *The Case for Doing Nothing About Institutional Investors' Common Ownership of Small Stakes in Competing Firms* 19–20 (Univ. of Mo. Sch. of L., Legal Stud. Rsch. Paper No. 2018-21, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3173787 [<https://perma.cc/8MEV-6CR2>].

79. Lambert & Sykuta, *supra* note 78, at 19–20.

80. Slemrod, *supra* note 3, at 42–43 (explaining that tax policy that facilitates tax evasion can benefit customers through lower prices).

81. Prior to its reorganization in 1999, the IRS Audit and Collection offices were divided geographically. Today, the IRS is split into four operating divisions: Wage and Investment; Small

faced a continual shortfall in the number of revenue agents and specialists necessary to support its audit efforts⁸²—a multi-stage process that includes selecting returns for audit, identifying possible return positions, proposing tax adjustments, and finally, collecting amounts due.⁸³ As the remainder of this section shows, flooding can harm the effectiveness of each of those stages.

1. Audit Selection

The LB&I selects returns for audit based on several factors, including a company's suspected involvement in an abusive transaction and a computer-generated score that predicts the prospect of adjustments to that company's tax liability.⁸⁴ For example, a deduction is likely to raise a "red flag" if it has changed dramatically from one tax year to another or if it is otherwise unusual or "suspicious-looking."⁸⁵ These red flags are critical in helping the agency identify aggressive returns.⁸⁶

However, when the *general* level of tax avoidance surges, red flags lose their meaning. Their growing prevalence makes it more difficult for the IRS to identify which returns deserve further scrutiny. And, if the levels of avoidance remain high, the IRS's standards for initiating an audit may change. What previously constituted cause for an audit may no longer trigger a tax examination. Flooding can, therefore, diminish the usefulness of what has long been a vital audit selection technique.

A recent review of IRS audits demonstrates the negative effect of flooding on enforcement patterns. According to that report, in 2010, the IRS

Business/Self-Employed; Large Business and International; and Tax Exempt and Government Entities. See Edward L. Froelich, *United States*, in *THE TAX DISPUTES AND LITIGATION REVIEW* 327 (Simon Whitehead ed., 2nd ed. 2014).

82. James Thorne, *Years of Budget Cuts Shrink the IRS, and Corporations Are the Big Winners*, CNBC (May 12, 2018, 10:00 AM), <https://www.cnbc.com/2018/05/11/budget-cuts-shrink-the-irs-and-corporations-are-the-big-winners.html> [<https://perma.cc/P3VT-652B>]; see also TRAC IRS, *supra* note 23. However, in August 2022, the House passed the Inflation Reduction Act which includes an additional \$80 billion in funding for the tax agency over a ten-year period. See Alan Rappeport, *Yellen Directs I.R.S. to Embark on \$80 Billion Overhaul Plan*, N.Y. TIMES (Aug. 17, 2022), <https://www.nytimes.com/2022/08/17/business/janet-yellen-irs-overhaul.html> [<https://perma.cc/KUF9-KESQ>]. Some of this funding will be used to beef-up enforcement and help the IRS collect more unpaid taxes, especially from large corporations and high-net-worth individuals. *Id.*

83. The LB&I examination process has three stages (assuming that a tax audit has been initiated): planning (the phase that determines the scope of the audit, the issues to be examined, and the timeline); execution (where the audit team determines the facts and applies the law to the facts); and resolution (where the parties reach an agreement). See INTERNAL REVENUE SERV., LARGE BUSINESS & INTERNATIONAL EXAMINATION PROCESS (2016), <https://www.irs.gov/pub/irs-utl/p5125.pdf> [<https://perma.cc/4HVU-94QM>]. In the following analysis, the first two phases—planning and execution—will be viewed as part of the second phase, which will be termed "case development."

84. See Nessa et al., *supra* note 46, at 6.

85. Raskolnikov, *supra* note 49, at 589–91.

86. *Id.* at 589.

conducted audits on 431 of the largest (so-called “giant”) corporations, representing an audit rate close to 100%.⁸⁷ By 2020, the audit rate among giants had dropped significantly, to about 38%.⁸⁸ Despite the fact that the number of giants increased from 557 in 2010 to 755 in 2020,⁸⁹ and even in the face of the escalating tax-avoidance behavior adopted by public corporations,⁹⁰ the IRS audited significantly fewer companies (285) in 2020 than it did at the beginning of the previous decade.⁹¹ This reduction might realistically equate to approximately \$15 billion in lost tax revenue every year, given that the audit of a typical giant company turns up, on average, \$31.6 million in tax.⁹² Moreover, a report from 2017 showed that, since 2010, the time devoted by the IRS to the audits it did conduct had decreased by more than half, suggesting that the agency’s thoroughness might also have been detrimentally affected.⁹³

The LB&I is also responsible for the Large Corporate Compliance (LCC) Program, pursuant to which selected companies are subject to annual auditing.⁹⁴ Program inclusion is dynamic: companies can be placed on or removed from the program based on a variety of criteria including size, the complexity of their returns, and tools that classify returns as high, medium, or low risk.⁹⁵ But, realistically, the number of companies that can be included in the program has to be capped. Logically, then, as more companies take on more aggressive tax planning, not all of them can be included in the program.⁹⁶ In other words, the escalating tax-avoidance levels can also change the benchmark for tax risk that leads to inclusion in the program.

87. See TRAC IRS, *supra* note 23.

88. *Millionaires and Corporate Giants Escape IRS Audits Again in FY 2020*, TRAC IRS (Mar. 18, 2021), <https://trac.syr.edu/tracirs/latest/641/#~:text=Now%20with%20less%20than%20a,dollars%20owed%20the%20U.S.%20Treasury> [https://perma.cc/X2P4-FED8].

89. *Id.*; TRAC IRS, *supra* note 23.

90. See *supra* notes 8–11 and accompanying text.

91. See TRAC IRS, *supra* note 88.

92. See TRAC IRS, *supra* note 23.

93. *Id.*

94. Michelle Hanlon, Lillian Mills & Joel Slemrod, *An Empirical Examination of Corporate Tax Noncompliance* 6–7 (Ross Sch. of Bus. at the Univ. Mich., Working Paper No. 1025, 2005), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=891226 [https://perma.cc/S9AM-B4YM].

95. LCC assignment is based on a points system involving seven main criteria: (1) gross assets; (2) gross receipts; (3) operating entities; (4) number of industries; (5) total foreign assets; (6) related transactions; and (7) foreign taxes paid. See Benjamin C. Ayers, Erin M. Towery & Jeri K. Seidman, *Taxpayer Behavior Under Audit Certainty* 58 (Sept. 2015) (unpublished manuscript), <https://www.irs.gov/pub/irs-soi/15rescontowery.pdf> [https://perma.cc/2B7R-VWTP]. Each criterion has a certain point-value, and a firm is assigned to the LCC program if it has twelve or more points, although those with fewer than twelve points can also be assigned to the program. *Id.*

96. See Nessa et al., *supra* note 46, at 20 (showing that a reduction of 1 in the standard deviation of the IRS enforcement budget is associated with a 2.3% reduction in audit probability, thereby highlighting the link between tax-enforcement resources and audit risk).

2. Case Development

Once a tax audit is initiated, a case enters the development phase.⁹⁷ Here, the audit team is required to verify the accuracy of the taxpayer's self-assessment of its tax liability, uncover any illegitimate tax positions on the return, and propose deficiencies. To do so, the team must gather and review relevant information about the company and its tax positions, and also apply the law to the relevant facts and understand the tax implications of the issues at stake.⁹⁸ The effectiveness of this stage essentially determines the success of the entire audit procedure.

Building the case for the purpose of compiling the audit report entails a massive information exercise for the agency, making this the most time- and resource-consuming phase of the audit procedure.⁹⁹ Therefore, we should expect the effect of the escalating levels of tax avoidance, which exhaust the agency's limited resources, to be most discernible during this stage,¹⁰⁰ and there is empirical evidence to support this inference. Confidential data on corporate audits conducted from 2002 through 2014 (shared by the IRS for the purpose of the academic study in question) show that there is a significant and economically meaningful positive relationship between the resources available to the IRS and the incidence and magnitude of proposed deficiencies.¹⁰¹ For example, an increase of 1 in the standard deviation of IRS resources is associated with a 3.2% increase in the probability of the IRS proposing a deficiency during a tax audit.¹⁰²

The different ways flooding is achieved might also have contrasting consequences for the effectiveness of this stage. If, for example, a large number of companies file noncompliant returns or adopt a broad range of

97. At the beginning of the audit, the audit team performs background research on the taxpayer and assesses the overall risk to identify questionable tax positions and determine the scope of the audit. See Froelich, *supra* note 81, at 332. The issues they select for deeper scrutiny are likely to become the focus of the audit. *Id.* In the past, a local team "classified" the return and chose the issues for examination. See Victoria Sherlock, *Tulane Tax Institute: The Impacts of LB&I's Restructuring and Other Relevant IRS Initiatives*, KPMG (Nov. 9, 2016), <https://slideplayer.com/slide/12160446/> [<https://perma.cc/NAS7-6QJ7>]. Today, the issues are centrally selected, developed, and monitored. *Id.* The addition of other tax issues must receive approval before the scope of the tax examination is extended. *Id.*

98. See INTERNAL REVENUE SERV., *supra* note 83.

99. See Nessa et al., *supra* note 46, at 21–23, 25. During this stage, the IRS issues Preliminary Information and Document Requests (IDRs) to the audited firm, and it regularly holds meetings and informal conversations with the company if needed.

100. This is especially true for large publicly held companies that typically have the resources and willingness to aggressively defend and contest tax positions. In that context, see Hanlon et al., *supra* note 94, at 13–14, attributing the correlation between the size of a firm and tax-audit outcomes to the superior ability of large companies to contest IRS proposals. See also I.R.S. News Release IR-2006-94 (June 13, 2006).

101. See Nessa et al., *supra* note 46, at 27.

102. *Id.* at 21. This change was calculated in comparison to the base probability of the IRS proposing a deficiency. *Id.*

tax positions, that type of flooding would likely impair the success of the case-development stage. In contrast, if commonly owned companies take advantage of similar tax-planning opportunities, they might make it easier for the IRS to identify and challenge the tax positions.¹⁰³ The assumption that commonly owned companies are more likely to adopt similar tax positions corresponds with empirical evidence indicating that a company's tax-avoidance policies are positively associated with the proportion of companies held by the same institutional investors employing the same policies.¹⁰⁴

However, as previously discussed, it could also be the case that, when a large number of companies are less compliant, a greater portion of the noncompliant companies will never face an audit simply due to insufficient tax-agency resources. Moreover, by focusing on these popular tax positions, the audit team might be distracted from other questionable tax positions. Recognizing the inherent limitations in addressing numerous issues during an audit and the tendency of revenue agents to focus on areas where avoidance is more discernible,¹⁰⁵ it becomes imperative for agents to also look at areas where tax avoidance is less conspicuous and warrants closer scrutiny.

The applicable statute of limitations may also play a role in these situations. The IRS has three years from the time a return is filed to assess any additional tax due with respect to that return.¹⁰⁶ To avoid extensions, the audit team might complete its examination even if it has not had the chance to fully understand the relevant facts and their tax implications. The higher the level of tax aggressiveness of an audited firm, the longer it takes to conduct an exhaustive and efficient audit.¹⁰⁷ Under such circumstances,

103. Such a scenario is particularly plausible considering the IRS's transformation toward issue-based examinations and the LB&I compliance campaign, which identifies a selection of prevalent tax strategies that are to be targeted across-the-board by IRS personnel. See *The IRS Large Business and International Division (LB&I) Announces the Approval of 13 Additional Compliance Campaigns*, IRS (Jan. 31, 2017), <https://www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns> [<https://perma.cc/T46T-TALF>]. The LB&I compliance campaign is based on the view that "compliance issues that present risk require a response in the form of one or multiple treatment streams to achieve compliance objectives." *Id.* Widespread adoption of the same strategy can cause that tax position to become the target of a compliance campaign.

104. C.S. Agnes Cheng, Zeyu Sun & Jing Xie, *Common Equity Blockholders and Diffusion of Tax Avoidance 3* (Mar. 21, 2018) (unpublished manuscript), <https://www.lsu.edu/business/accounting/files/researchseries/Draft-Peer-effect-on-tax-avoidance-2018Mar21.pdf> [<https://perma.cc/DN7J-J8NG>].

105. See Raskolnikov, *supra* note 49, at 589.

106. I.R.C. § 6501(a). If there is a year or less remaining on the statute of limitations, the audit team might ask the taxpayer to agree to an extension (usually, no more than a year). See § 6501(c)(4); see also Froelich, *supra* note 81, at 334.

107. Hanlon et al., *supra* note 94, at 11 ("[I]t is precisely when the discrepancy between the proposed deficiency and the tax liability agreed to by the taxpayer is large that the case is likely to be subject to a protracted appeals process.").

the desire to comply with the statute of limitations can jeopardize the thoroughness of the audit, resulting in fewer adjustments.¹⁰⁸

3. *Collection of Deficiencies*

Once the audit is deemed complete, the IRS proposes adjustments where necessary and negotiates settlements. If the taxpayer agrees to these adjustments, its tax liability will be modified accordingly. The goal of the deficiency-collection phase is to reach an agreement on the tax treatment of each issue examined.¹⁰⁹

As a general rule, both sides usually prefer to compromise and settle at the examination stage.¹¹⁰ This would be particularly true when flooding is in effect, when there would be many more noncompliant returns awaiting the IRS's attention. Considering the resources invested so far by the audit team, the IRS might well deem it preferable to simply settle the case at that juncture and move on to the next audit.

But the IRS's desire to resolve the case swiftly can come at the expense of the number of deficiencies collected, since an audited company might agree to settle only under conditions that are suboptimal from the IRS's perspective. A company might agree, for example, to settle on the most questionable tax positions but refuse to do so with respect to less aggressive positions, which, under other circumstances, would also have been successfully challenged.¹¹¹

108. If the team is unable to complete the examination, it might issue a protective notice of deficiency that is usually based on the previous year's tax-return liabilities, adjusted upward. Froelich, *supra* note 81, at 334.

109. See INTERNAL REVENUE SERV., *supra* note 83.

110. See Kent W. Smith & Loretta J. Stalans, *Negotiating Strategies for Tax Disputes: Preferences of Taxpayers and Auditors*, 19 LAW & SOC. INQUIRY 337, 345 (1994); see also INTERNAL REVENUE SERV., *supra* note 83, at 4 ("LB&I encourages the use of all appropriate issue resolution strategies . . ."). The alternative of going forward to the next level (the IRS Office of Appeals) or the court is burdensome for both parties. If there is no agreement, the case will go to the IRS Office of Appeals. See Froelich, *supra* note 81, at 339. If efforts to resolve the issue within the IRS fail, the taxpayer can file a suit. See *id.* at 340–43. In addition to the high litigation costs, the tax-related information and the RAR become public knowledge. This is something that publicly held companies would prefer to avoid, especially given the sensitivity of tax data and the perception that tax avoidance is politically charged. From the IRS's perspective, tax litigation in court is undesirably resource-consuming because "IRS personnel who were involved during the tax audit phase may, in fact, be assigned to the case in Tax Court or act in some consultative capacity to the IRS trial team." See *id.* at 343.

111. Nessa et al., *supra* note 46, at 29 (suggesting that, when resources are constrained, the IRS proposes adjustments to the weakest tax positions). However, the authors also show that IRS resources are negatively correlated with proposed deficiencies. *Id.* at 23–25; see also Hanlon et al., *supra* note 94, at 12 (showing that, although the largest companies have their tax returns open for an extended period, "the proposed deficiency rate in those open cases [is] much less than for smaller companies, just 18.8 percent compared to rates ranging from 25.1 percent to 46.5 percent for the other asset size classes" (emphasis omitted)).

Evidence of the detrimental effect of flooding on the collection of deficiencies can be inferred from a recent empirical study that examined the impact of tax uncertainty on dividend payouts in companies with varying institutional ownership levels.¹¹² That study found that dividend payouts among companies with higher levels of institutional ownership remained steady even when there were high levels of tax uncertainty,¹¹³ suggesting that these tax-avoiding companies are less likely to experience a significant decrease in their cashflows in the future.

My proposed flooding theory may shed light on these surprising results. Institutional investors forge the link between corporate tax avoidance and settlement negotiations by creating an environment that overwhelms the tax agency. Thus, it makes sense that the impact of IRS audits on the level of tax adjustments and future free cashflows is less significant in companies owned by these institutional investors. And this would suggest that the IRS is leaving billions of dollars in uncollected revenue on the table when auditing commonly owned companies.

D. Making the Case for the “Corporate Flooding” Strategy

Over the past decade, tax research has begun to acknowledge the potential effect of ownership patterns on a firm’s tax behavior.¹¹⁴ The underlying assumption is that different shareholders might have distinct trade-off points when it comes to tax avoidance, such that changes in ownership structure could explain differences in corporate tax-avoidance levels.¹¹⁵ In accordance with that prediction, several studies have analyzed the cross-sectional variation in the tendency of firms with different

112. Harald Amberger, *Tax Uncertainty and Dividend Payouts* (WU Vienna Univ. of Econ. & Bus., Int’l Tax’n Rsch. Paper Series No. 2017–04, 2017), <https://research.wu.ac.at/en/publications/tax-uncertainty-and-dividend-payouts-12> [<https://perma.cc/6955-B77Y>].

113. *Id.* at 22–23. The coefficient of annual Cash Effective Tax Rates over five previous years was used as a proxy for tax uncertainty, which is, itself, often used as a proxy for the level of tax avoidance. *Id.* at 1 (“Uncertainty in this regard stems from ‘grey area’ tax avoidance, which includes tax positions with ex-ante uncertainty and a high likelihood of being overturned in a tax audit.”); see also Scott Dyreng, Michelle Hanlon & Edward L. Maydew, *When Does Tax Avoidance Result in Tax Uncertainty?*, 94 ACCT. REV. 179 (2019) (explaining the strong correlation between tax avoidance and tax uncertainty).

114. See, e.g., Mihir A. Desai & Dhammika Dharmapala, *Taxation and Corporate Governance: An Economic Approach* 10–13 (Apr. 2007) (unpublished manuscript), <https://ssrn.com/abstract=983563> [<https://perma.cc/QP94-RSGV>]; Michelle Hanlon & Shane Heitzman, *A Review of Tax Research*, 50 J. ACCT. & ECON. 127, 144–45 (2010).

115. Hanlon & Heitzman, *supra* note 114, at 138–39; see also Khan et al., *supra* note 16, at 102. The potential effect of ownership structure on corporate tax-avoidance levels is largely the result of the diverse characteristics of different shareholders, such as their attitude toward risk, level of concentration, and investment horizon.

ownership structures to engage in tax avoidance.¹¹⁶ Following this line of research, a few recent empirical studies have explored the effect of institutional ownership, particularly quasi-indexers, on the tax behavior of their portfolio companies.¹¹⁷ These studies found a significant positive correlation between quasi-indexers' ownership of public corporations and their corporate tax-avoidance levels.¹¹⁸

As noted earlier, to investigate the relationship between quasi-indexer ownership and tax compliance, these studies utilized two commonly used financial measures that indicate a firm's tax-avoidance level: GAAP ETR and Cash ETR. Using an index-reconstitution method to isolate exogenous shock to institutional ownership, the researchers were able to capture fluctuations in the tax burden of companies following index inclusion. Specifically, two studies estimated the tax-avoidance levels of companies at the top of the Russell 2000 and compared them to those of companies at the bottom of the Russell 1000. Such settings are useful for examining the causal link between institutional investors and corporate tax avoidance since firms close to the cutoff on either side are very similar in size, and the resulting discontinuity in quasi-indexer ownership at the Russell 1000/2000 index cutoff is caused by index assignment, not firm policies or sizes.

116. See, e.g., Brad A. Badertscher, Sharon P. Katz & Sonja O. Rego, *The Separation of Ownership and Control and Corporate Tax Avoidance*, 56 J. ACCT. & ECON. 228, 229 (2013) (indicating that PE-backed firms avoid more taxes than management-owned firms); C.S. Agnes Cheng, Henry He Huang, Yinghua Li & Jason Stanfield, *The Effect of Hedge Fund Activism on Corporate Tax Avoidance*, 87 ACCT. REV. 1493 (2012) (showing that firms that are targeted by hedge funds experience an increase in tax avoidance after the intervention); Chen et al., *supra* note 16 (indicating that institutional ownership is positively correlated with tax avoidance). For a discussion on the potential difficulties associated with the empirical research of tax avoidance, and particularly on the measurements used to calculate tax avoidance and the limits they impose on the interpretation of the result, see generally Hanlon & Heitzman, *supra* note 114, at 139–43.

117. See *supra* note 16 and accompanying text.

118. Chen et al., *supra* note 16; Khan et al., *supra* note 16. These empirical studies did not examine the direct correlation between common ownership and the level of tax avoidance but rather that of quasi-indexer ownership. Nonetheless, quasi-indexer ownership constitutes a good proxy for common ownership since the index-weighting mechanism creates variation in institutional ownership around the relevant threshold that is presumably exogenous to a firm's tax behavior. Compare Appel et al., *supra* note 18, at 119, with Yupeng Lin, Ying Mao & Zheng Wang, *Institutional Ownership, Peer Pressure, and Voluntary Disclosures*, 93 ACCT. REV. 283 (2018) (both studies use the cut-off point between the two indexes, Russell 1000 and Russell 2000, which leads to a significant increase in quasi-indexer ownership and allows to establish causal evidence on the effect of these institutional investors). Quasi-indexer ownership is also a good proxy for common ownership as the holdings of large asset management institutions that manage mainly index-based mutual funds and ETFs are greatly affected by index reconstitutions. A 2013 study found that higher levels of ownership by long-horizon institutional investors are associated with decreased tax avoidance, especially for companies with otherwise poor governance. See Inder K. Khurana & William J. Moser, *Institutional Shareholders' Investment Horizons and Tax Avoidance*, 35 J. AM. TAX'N ASS'N 111 (2013). However, these results should be interpreted carefully as they suffer from endogeneity of ownership concentration. This problem has been solved in the more recent studies that utilize an exogenous shock (in the form of index exclusion/inclusion) to study the effect of institutional ownership on corporate tax avoidance.

Due to the value-weighted nature of the indices, broadly diversified institutional investors, who likely benchmark these indices, hold stakes in companies at the top of the Russell 2000 that are 13.2% higher than their positions at the bottom of the Russell 1000.¹¹⁹ The results of these studies show that companies with higher levels of quasi-indexers and, accordingly, higher levels of common ownership,¹²⁰ have both significantly lower GAAP ETR and Cash ETR compared to companies at the bottom of the Russell 1000. According to Khan et al., companies at the top of the Russell 2000 have 5.1% lower GAAP ETR and 7.0% lower Cash ETR than companies at the bottom of the Russell 1000.¹²¹ Chen et al. used the same reconstitution index. They documented that GAAP ETR is 3.2% lower among companies at the top of the Russell 2000 compared to those at the bottom of the Russell 1000, while Cash ETR is 4.8% lower.¹²²

Both studies further indicate a preference among institutional investors for cash over GAAP tax savings, implying a potential emphasis on cash flows rather than profits. If this preference indeed holds true, tax planning opportunities that free up cash flows are more likely to flourish in the wake of common ownership.

Although the documented fluctuations can be attributed to a variety of factors and are not necessarily reflective of abusive tax avoidance,¹²³ tax researchers have generally viewed incremental tax avoidance following an index inclusion as more likely to stem from aggressive tax behavior. The theory is that companies begin by exploiting tax-planning strategies that are less aggressive, and, as the level of GAAP ETR or Cash ETR declines, they move to a more aggressive segment of the tax-avoidance spectrum.¹²⁴

Therefore, the findings of these empirical studies suggest that common institutional shareholding compresses the cross-sectional distribution of tax rates, pushing portfolio companies toward a higher level of tax avoidance.¹²⁵ And this significant increase in tax noncompliance corresponds to millions

119. See Chen et al., *supra* note 16.

120. See *supra* note 18 and accompanying text.

121. Khan et al., *supra* note 16, at 109.

122. Chen et al., *supra* note 16, at 286.

123. On the limitations of ETRs as tax-avoidance proxies, see Michelle Hanlon, *What Can We Infer About a Firm's Taxable Income from Its Financial Statements?*, 56 NAT'L TAX J. 831 (2003); Jennifer Blouin, *Defining and Measuring Tax Planning Aggressiveness*, 67 NAT'L TAX J. 875 (2014); and Casey M. Schwab, Bridget Stomberg & Junwei Xia, *What Determines ETRs? The Relative Influence of Tax and Other Factors* (Kelley Sch. of Bus., Rsch. Paper No. 18-92, 2021), <http://dx.doi.org/10.2139/ssrn.3281289> [<https://perma.cc/FTG3-BH99>].

124. See, e.g., Khan et al., *supra* note 16.

125. Chen et al., *supra* note 16, at 280 (arguing that the positive relationship between quasi-indexer ownership and tax avoidance is the result of these institutions' focus on better overall performance); Khan et al., *supra* note 16 (claiming that quasi-indexers lead to higher tax-avoidance levels through their effect on executive pay, while acknowledging that such investors might also be using more "subtle" and less visible ways to increase avoidance levels, such as engagement with management).

of dollars per year in unpaid taxes for the average commonly owned company.¹²⁶ Moreover, the observed increase in tax-avoidance levels validates the assumption that common institutional ownership alters the cut-off point of tax avoidance.¹²⁷ The flooding strategy and its detrimental effect on the effectiveness of tax enforcement can explain the change in firms' cost-benefit analysis of tax avoidance.

II. THE ROLE OF INSTITUTIONAL INVESTORS: THE MECHANISMS OF FLOODING

As the previous Part established, broadly diversified institutional investors stimulate an across-the-board increase in the tax-avoidance levels adopted by their companies, which triggers the practice of flooding. In this Part, I pinpoint potential causal pathways linking common ownership to higher tax-avoidance levels, which sheds light on the capacity of these powerful, sophisticated shareholders to shape their companies' tax behavior. I also analyze how the new noncompliant post-flooding environment formed under common ownership creates an independent incentive for companies to engage in tax avoidance.

A. Shareholder Attitudes Toward Tax-Related Monitoring

While the ability to influence a company's behavior is generally associated with shareholders exercising control rights,¹²⁸ institutional investors have historically been perceived as shareholders that do not flex

126. Bird and Karolyi estimated that a 0.2–0.3 percentage-point decrease in Cash ETR following Russell 2000 index reconstitution corresponds to a \$9.35 million reduction in cash taxes paid per year for the average company in the sample. See Andrew Bird & Stephen A. Karolyi, *Governance and Taxes: Evidence from Regression Discontinuity*, 92 ACCT. REV. 29, 38 (2017) (retracted). Although this article was retracted as it misstated the use of CRSP-based index membership in the main specifications, the study's estimations of the amounts of tax revenue losses associated with index reconstitutions remain unaffected by the misstatement regarding CRSP-based index membership. Therefore, they can still provide insights into the significant social costs associated with common institutional ownership.

127. Khan et al., *supra* note 16, at 117 ("The results suggest that ownership concentration has explanatory power for variation in tax avoidance."). In a 2005 study, Desai and Dharmapala argued that changes in the trade-off point of corporate tax avoidance associated with changes in institutional ownership might be attributed to the fact that these investors engage in monitoring and demand greater tax transparency so that their presence can mitigate the perception of managerial rent-extraction from opaque tax-avoidance activities, providing managers with a greater incentive to generate tax savings. See Mihir A. Desai & Dharmika Dharmapala, *Corporate Tax Avoidance and Firm Value* (Nat'l Bureau of Econ. Rsch., Working Paper No. 11241, 2005), <https://www.nber.org/papers/w11241> [<https://perma.cc/3UJ7-SXHG>].

128. Generally, control can be exercised through either vote or exit. More recently, scholars have begun to acknowledge the option of engaging with corporate management as a third mechanism to exercise control. See, e.g., Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuk-Strine Debate*, 12 N.Y.U. J.L. & BUS. 385 (2016).

their muscles in this regard.¹²⁹ In fact, institutional investors have traditionally been viewed as reactive: they regularly vote on management and shareholder proposals, yet they rarely submit or sponsor resolutions or run proxy fights.¹³⁰ In recent years, however, this assumption regarding the passivity of these institutions has gradually begun to crumble.¹³¹

The cause of this shift has been attributed to a number of explanations, with two notable factors being the declining costs of stewardship efforts—the expenses associated with shareholder oversight and active participation in governance affairs—and the prospect for greater marginal benefits derived from engaging in stewardship activities.

Let us turn, then, to examine how those and other theories about the increasing motivation of institutional investors to generally monitor their portfolio companies' behavior may also explain a rise in the specific monitoring of tax-avoidance behavior.

First, as institutional investors have increased their equity stakes in many public companies, the marginal benefit of a particular corporate action has grown accordingly. The higher stakes that institutional investors now own mean that, if they invest resources in stewardship to affect corporate policies that would improve firm value, these investors can substantially increase their portfolios' value.¹³² Similarly, by influencing their portfolio companies' tax behavior to encourage greater tax avoidance, these increasingly concentrated investors can reap considerable benefits in the form of greater portfolio returns, higher dividends, and increased share value.¹³³ The superior returns would also result in higher revenue from

129. See, e.g., Gilson & Gordon, *supra* note 37 (explaining that the business model of financial intermediaries like mutual funds focuses on increasing AUM through superior relative performance and reduces their incentive and capacity to actively monitor their portfolio companies); see also Bebchuk et al., *supra* note 67, at 95–104; Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347, 1364–71 (2011).

130. Kahan & Rock, *supra* note 129, at 1370, 1376, 1430–31. The relatively small equity stakes that such investors have traditionally owned, combined with the structure of their management fees and the competition in the asset management industry, often do not make it worthwhile for them to invest resources in monitoring. See also Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 453–63 (1991).

131. See, e.g., Appel et al., *supra* note 18.

132. See, e.g., Einer Elhauge, *How Horizontal Shareholding Harms Our Economy—And Why Antitrust Law Can Fix It*, 10 HARV. BUS. L. REV. 207, 236 (2020). Moreover, because institutional owners' voting and engagement are often conducted at the fund-family level by institutions that also have hundreds of billions of dollars in active funds, even low-cost passive funds can influence the governance and policies of public corporations by using their sponsor. See Ann M. Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TRANSACTIONS: TENN. J. BUS. L. 175, 177 (2017). However, firm-value improvement may also benefit rival mutual funds given the similarity in the portfolio holding among index funds tracking the same market indices. This possibility can potentially discourage institutional investors from investing resources in monitoring, as competing institutions will benefit from any intervention without bearing the costs associated with it. See, e.g., Gilson & Gordon, *supra* note 37, at 890–92.

133. See, e.g., Chaffee, *supra* note 6, at 107.

management fees, which are typically a percentage of assets under management.¹³⁴ This would also help attract new investors and improve inflows.

Second, because exiting is not an option for many institutional investors,¹³⁵ they may be incentivized to devote resources to actions that could improve corporate profits over the long term. Even if those monitoring costs are high, they can be amortized over time. Similarly, establishing incentives for companies to invest in tax planning can be a long-term investment that can potentially reduce a company's tax payments for many years and positively affect profits.¹³⁶

Third, the shift in monitoring by institutional investors can also be attributed to the presence of activist shareholders.¹³⁷ Compared to their institutional counterparts, activist shareholders have a stronger motivation to engage in costly monitoring activities as they invest a large proportion of their wealth in a small number of companies.¹³⁸ By piggybacking on the work of activists, institutional investors can take positions and promote particular actions at a relatively low cost.¹³⁹ Large money managers indeed claim to have a positive interactive effect with activist investors, making

134. Jonathan B. Berk & Richard C. Green, *Mutual Fund Flows and Performance in Rational Markets*, 112 J. POL. ECON. 1269 (2004) (demonstrating the positive correlation between portfolio performance and subsequent net-inflows to the fund).

135. For passive index funds, exiting a firm included in the market index they track is not an option because such funds are required to follow the relevant index. Actively managed funds, due to their equity stakes, might avoid exiting because they can sometimes suffer a substantial negative price effect if they sell a large position. See, e.g., Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243, 1258 (2020).

136. Thomas Doellman, Fariz Huseynov, Tareque Nasser & Sabuhi Sardarli, *Do Mutual Funds Consider Tax Avoiding Firms Too Risky?* 10–11 (Jan. 2018) (unpublished manuscript), <http://finaconferences.org/SanDiego/Papers/MFTA%20Jan18.pdf> [<https://perma.cc/H6AR-RQPQ>]; Scott D. Dyreng, Michelle Hanlon & Edward L. Maydew, *Long-Run Corporate Tax Avoidance*, 83 ACCT. REV. 61, 70–73 (2008) (finding that low annual ETR are persistent over time).

137. See Gilson & Gordon, *supra* note 37.

138. *Id.* This is the result of their relatively large and concentrated stakes in the companies they target, the stronger financial incentive of hedge fund managers to capture a significant portion of the returns, and the lower incidence of “conflicts of interest” within the hedge fund portfolio. See also Alon Brav, Wei Jiang & Hyunseob Kim, *Hedge Fund Activism: A Review*, 4 FOUNDS. & TRENDS FIN. 185, 186–87 (2009).

139. See Gilson & Gordon, *supra* note 37, at 896–902. The likelihood of such a scenario also incentivizes the activist shareholders themselves to target ex-ante companies with high institutional ownership. See Ian R. Appel, Todd A. Gormley & Donald B. Keim, *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism*, 32 REV. FIN. STUD. 2720, 2723 (2019) (“Combined, our results suggest that the presence of passive institutions increases activists’ willingness to engage in costlier forms of activism. . . . The increased willingness to undertake such campaigns could reflect lower expected costs of such campaigns (e.g., lower coordination costs) and/or higher expected benefits (e.g., increased likelihood of winning) when a larger proportion of a firm’s equity is held by passive investors.”).

hedge funds more likely to invest in monitoring efforts.¹⁴⁰ This collaboration enables institutional investors to enjoy information spillover, which they can leverage in their stewardship activity.

Likewise, in the tax-avoidance setting, tax-inefficient companies are often targeted by hedge funds,¹⁴¹ which tend to influence the tax behavior of their portfolio companies by suggesting specific tax strategies.¹⁴² Under those circumstances, the costs for other institutional investors associated with generating incentives for portfolio companies to avoid taxes are lower. Moreover, concerns over intervention might induce companies to focus on increasing their tax-avoidance levels in the first place, in an attempt to avoid such intervention.¹⁴³

B. Low-Cost Monitoring Under Common Ownership

In recent years, monitoring has become even more economical for institutional shareholders due to the unique advantages associated with their common, yet concentrated, equity stakes. Specifically, institutional investors can use a range of monitoring and stewardship mechanisms, two of which I detail next, that have the potential to influence the behavior of a large number of their portfolio companies without incurring significant expense and without having to acquire firm-specific knowledge.

1. The One-Size-Fits-All Approach

Common owners are often asked to vote on the same type of governance matters across their portfolio holdings.¹⁴⁴ By voting horizontally on all such ballots, common institutional owners can spread the costs associated with

140. See Matthew J. Mallow, Asset Management, Index Funds, and Theories of Corporate Control 13 (Nov. 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3483573 [<https://perma.cc/QZ2Y-XSBT>].

141. Cheng et al., *supra* note 116, at 1495 (showing that firms that are targeted by hedge funds later increase their level of tax avoidance, and that such an effect is empirically associated with the hedge funds' prior record of implementing tax changes, as well as with their interest in tax planning).

142. See, e.g., Alexandra Stevenson & Chad Bray, *Walgreen Shies Away from Moving Its Tax Base to Britain*, N.Y. TIMES (Aug. 6, 2014, 6:27 AM), <https://dealbook.nytimes.com/2014/08/06/walgreen-to-pay-5-27-billion-plus-shares-for-alliance-boots> [<https://perma.cc/PF7V-7ZVS>]; Kasmira Jefford, *IHG Shareholder Pushes for Tax Inversion Bid*, CITY A.M. (Aug. 4, 2014, 8:22 PM), <http://www.cityam.com/1407198172/ihg-shareholder-pushes-tax-inversion-bid> [<https://perma.cc/C3DK-TBBT>].

143. See Gail Weinstein, Warren S. de Wied & Philip Richter, *The Road Ahead for Shareholder Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 13, 2019), <https://corpgov.law.harvard.edu/2019/02/13/the-road-ahead-for-shareholder-activism/> [<https://perma.cc/SL5R-H5G9>]; Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U. L. REV. 971, 984 (2019). Both papers explain that companies that wish to avoid intervention by activists are likely to take actions in the same direction hedge funds would have wanted them to take in the case of an activist's intervention.

144. See, e.g., Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. 983, 1001–02 (2020).

researching the issue at stake and exercising their control rights, thus avoiding the need to invest resources in acquiring firm-specific knowledge.¹⁴⁵ But this tactic may be especially valuable to those institutional investors with a rapidly growing number of portfolio companies, particularly if the resources allocated to stewardship activities do not keep pace.¹⁴⁶ As I set out in Section C, a unified position can facilitate some of the specific mechanisms used by institutional investors to increase corporate tax-avoidance levels.

2. *Harnessing Herd Behavior*

With common ownership, the ability to affect the behavior of companies in a portfolio is not necessarily contingent on exercising control over them. By influencing the behavior of only a small number of key companies—most likely market leaders in their respective industries—common institutional owners can indirectly influence other commonly owned companies, which are likely to instinctively mimic such behavior. This so-called “herding effect” has been observed with companies under common ownership.¹⁴⁷ The existence of such herd behavior among commonly owned companies suggests that they view the behavior of other portfolio companies held by the same institutional investors as signaling the attitude or preferences of common owners.¹⁴⁸

In the tax-avoidance context, empirical evidence shows a convergence in companies’ ETR following index reconstitution.¹⁴⁹ Indeed, the data illustrate that the level of tax avoidance, measured by different tax-avoidance indicators such as ETR and book–tax difference, is correlated with exogenous variations in the tax avoidance of other index companies.¹⁵⁰

145. The viability of this strategy is limited to cases in which the same governance issue is being voted upon and in which the common institutional owner would want the vote to be cast the same way.

146. See Bebchuk & Hirst, *supra* note 15 (arguing that the stewardship resources of large institutions are inadequate compared to the number of their portfolio companies). However, according to Elhauge, staff for voting and stewardship have recently expanded by 65% at BlackRock, 110% at Vanguard, and 37.5% at State Street. Einer Elhauge, *The Causal Mechanisms of Horizontal Shareholding*, 82 OHIO ST. L.J. 1, 68 (2021).

147. See, e.g., Michael J. Jung, *Investor Overlap and Diffusion of Disclosure Practices*, 18 REV. ACCT. STUD. 167 (2013) (demonstrating that the disclosure practices of commonly owned intra-industry firms are positively correlated with a higher overlap in large institutional investors, and concluding that higher overlap might function as a communication channel and feedback mechanism to help facilitate the diffusion of disclosure practices); Massimo Massa & Alminas Žaldokas, *Information Transfers Among Co-Owned Firms*, 31 J. FIN. INTERMEDIATION 77, 78 (2017) (suggesting that common ownership bondholders are able to use the financial performance of the commonly owned firms as signals from which to draw conclusions regarding the common owners’ attitude toward lenders).

148. Massa & Žaldokas, *supra* note 147, at 78.

149. Cheng et al., *supra* note 104.

150. *Id.* (manuscript at 3) (“[F]irms’ tax avoidance is significantly correlated with exogenous variations in tax avoidance of their CIB [common institutional blockholders] peers.”).

These findings support the idea that common ownership creates a new, higher benchmark for tax avoidance, to which other companies then adhere. Also, with the higher benchmark, companies are less likely to be concerned about appearing too aggressive as common ownership pushes up the benchmark for tax avoidance and modifies the IRS's standards for triggering a tax audit.¹⁵¹ Herd behavior can, therefore, accelerate flooding with minimum effort on the part of institutional investors.

As the herding effect is often associated with mimicking the behavior of large companies and market leaders, these companies are better positioned to influence other commonly owned companies and promote herding. Therefore, institutional investors can target their stewardship efforts toward such companies.¹⁵² Moreover, large, well-resourced companies are likely to be better placed to gather private information about their shareholders' optimal level of tax avoidance.¹⁵³

C. The Practices that Facilitate "Corporate Flooding"

In order to facilitate the practice of flooding, common institutional owners need to put in place incentives for their portfolio companies to simultaneously engage in more tax avoidance. The responsiveness of the companies to such incentives will automatically overwhelm the tax agency, allowing the flooding effect to materialize. Here, I explore the specific pathways that cause public companies to increase their tax-avoidance levels. I contend that there are several mechanisms that can connect common institutional ownership to tax-avoidance behavior, some of which entail very light-touch communication between common owners and corporate management, if any.

151. See Christopher S. Armstrong, Stephen Glaeser & John D. Kepler, *Strategic Reactions in Corporate Tax Planning*, 68 J. ACCT. & ECON. 101232 (2019) (explaining that, according to game theory, many corporate tax decisions can be characterized as a "strategic reaction" that describes how a firm's decision varies depending on its competitors' anticipated tax behavior). Commonly owned firms are therefore likely to respond to changes in their competitors' tax avoidance due to concerns about being singled-out as noncompliant or overly compliant. Lower levels of avoidance raise concerns that the firm will appear less efficient or too conservative in its tax policies. Higher tax-avoidance levels can cause the firm to be viewed as particularly aggressive and draw unwanted scrutiny. On the ability of companies to estimate the tax avoidance levels of other companies based on their public disclosure and the utilization of such information, see *infra* note 200.

152. Cf. Azar et al., *Anticompetitive Common Ownership*, *supra* note 41, at 1550 (discussing the possibility that institutional investors focus their stewardship efforts on market leaders). Institutional investors do, indeed, devote more attention to larger companies, primarily because they constitute a higher proportion of their portfolios. See Mallow, *supra* note 140, at 30 (explaining that the reason for devoting resources to such firms has to do with the firms' size and influence on the portfolio performance).

153. See Armstrong et al., *supra* note 151, at 30. *Contra* Martin C. Schmalz, *Common-Ownership Concentration and Corporate Conduct* 25–26 (CESifo, Working Paper No. 6908, 2018) ("[M]anagers unilaterally act in the interest of their shareholders, and do not explicitly or tacitly coordinate with competitor firms.").

1. Regulatory Lobbying Efforts

Compensation contracts are generally perceived as a primary mechanism by which management can be incentivized to choose a tax-avoidance level that reflects shareholder preferences.¹⁵⁴ The potential usefulness of management pay as a mechanism to trigger tax avoidance is linked to the fact that the compensation of managers is often determined based on one or more performance measures (in particular, accounting-based performance metrics),¹⁵⁵ which are directly affected by tax expenses. These performance measures create powerful incentives and extreme sensitivity to levels of firm profits for corporate executives.¹⁵⁶ In some cases, the terms of the compensation terms-and-conditions may also generate “cliffs”: if profits cross a certain threshold, the manager receives a windfall; otherwise, virtually nothing.¹⁵⁷ Since executives often view increasing earnings in order to meet or beat targets as an important goal of tax planning, designing compensation packages with such characteristics is likely to incentivize them to more aggressively pursue tax-avoidance opportunities.¹⁵⁸ Thus, management compensation can help explain the incentives for managers to engage in tax avoidance.

In recent years, several empirical studies have examined the relationship between the components and characteristics of compensation packages and companies’ levels of tax avoidance. Those studies found a positive correlation between equity-based compensation and pay-for-performance

154. See, e.g., Hanlon & Heitzman, *supra* note 114, at 138 (applying Jensen and Meckling’s model and explaining that shareholders should strive to find a combination of control mechanisms and incentives that influence management to choose a tax-avoidance level closer to the target level to minimize agency costs); Armstrong et al., *supra* note 42, at 2 (arguing that various governance mechanisms, including managers’ incentive compensation contracts, can mitigate agency problems related to tax avoidance); Sonja Olhoft Rego & Ryan Wilson, *Equity Risk Incentives and Corporate Tax Aggressiveness*, 50 J. ACCT. RSCH. 775 (2012) (discussing the potential value of examining the compensation of those executives who have a more direct effect on tax policies, such as tax directors and managers).

155. Alex Edmans, Xavier Gabaix & Dirk Jenter, *Executive Compensation: A Survey of Theory and Evidence* 54 (Eur. Corp. Governance Inst., Fin. Working Paper No. 514/2017, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2992287 [<https://perma.cc/ETN4-3XMF>].

156. *Id.* at 15–19.

157. See Adi Libson, *Taking Shareholders’ Social Preferences Seriously: Confronting a New Agency Problem*, 9 U.C. IRVINE L. REV. 699, 709 (2019).

158. See, e.g., Khan et al., *supra* note 16 (showing that tax avoidance is used by management to increase net income margins and to meet or beat earnings expectations); John R. Graham, Michelle Hanlon, Terry Shevlin & Nemit Shroff, *Incentives for Tax Planning and Avoidance: Evidence from the Field*, 89 ACCT. REV. 991 (2014) (suggesting that tax-planning strategies are often marketed to public companies as a way to increase earnings).

sensitivity to tax avoidance, especially for well-governed companies and those with high levels of institutional ownership.¹⁵⁹

This observed positive association between equity-based compensation and institutional ownership,¹⁶⁰ bolstered by the statements of some of the largest asset management institutions,¹⁶¹ supports the premise that certain types of executive compensation packages may be linked to higher tax-avoidance levels. Indeed, some of the empirical studies that show a positive correlation between institutional ownership and tax avoidance have attributed it to the investors' influence on management pay.¹⁶² That influence would not be surprising, given that many institutional investors claim expertise in evaluating executive compensation and regularly vote on compensation structures in say-on-pay and other votes.¹⁶³ According to Azar et al., institutional investors discuss management pay in almost half of the engagement meetings they conduct every year.¹⁶⁴ And ownership in hundreds of companies provides institutional investors with the opportunity to gain economies of scale in monitoring compensation policy.

2. Private Engagement

Common owners can communicate their tax-related preferences or bottom-line expectations to management through direct engagement. This communication method, which seems to be a relatively effective way to influence management,¹⁶⁵ is becoming more common among asset

159. See, e.g., Rego & Wilson, *supra* note 154; Hanlon et al., *supra* note 94. But see Mihir A. Desai & Dharmika Dharmapala, *Corporate Tax Avoidance and High-Powered Incentives*, 79 J. FIN. ECON. 145, 173 (2006) (documenting a negative relationship between incentive compensation and tax sheltering for companies with weak corporate governance). Desai and Dharmapala also found that this correlation was mediated by institutional ownership and suggested a model in which tax sheltering and rent extraction are complementary activities that decrease when manager incentives are appropriately aligned. Their results were later disputed, and alternative explanations were suggested. *Id.*

160. See, e.g., Andres Almazan, Jay C. Hartzell & Laura T. Starks, *Active Institutional Shareholders and Costs of Monitoring: Evidence from Executive Compensation*, 34 FIN. MGMT. 5 (2005); Parthiban David, Rahul Kochhar & Edward Levitas, *The Effect of Institutional Investors on the Level and Mix of CEO Compensation*, 41 ACAD. MGMT. J. 200, 200–01, 204 (1998).

161. For example, State Street Global Advisors stated in its 2019 Proxy Voting and Engagement Guidelines that it supports management proposals on executive compensation where there is “a strong relationship between executive pay and performance over a five-year period.” STATE ST. GLOB. ADVISORS, PROXY VOTING AND ENGAGEMENT GUIDELINES 13 (2023), <https://www.ssga.com/us/en/institutional/etfs/capabilities/esg/asset-stewardship/asset-stewardship-report-library/world-proxy-voting-engagement-guidelines-2019> [<https://perma.cc/MXU3-XMH2>]. It also claims it believes that compensation packages should cause an alignment with shareholder interests. *Id.*

162. See Khan et al., *supra* note 16, at 104; Chen et al., *supra* note 16, at 290–91.

163. See Hemphill & Kahan, *supra* note 78, at 1415.

164. According to these authors, “passive” investors claim to address management pay structures in 45% of engagement meetings. Azar et al., *Anticompetitive Common Ownership*, *supra* note 41, at 1556.

165. See, e.g., Mallow & Sethi, *supra* note 128, at 392–94.

managers.¹⁶⁶ According to research from the last decade, asset management institutions now conduct hundreds of engagement meetings every year in the form of direct conversations with companies and through “brief phone calls, email exchanges, or even short meetings.”¹⁶⁷ In a 2021 study, 63% of institutional investors admitted they had attempted to influence corporate managers via direct discussions.¹⁶⁸

Private engagement can lead to higher levels of tax avoidance in various ways. One possibility is that institutional investors do not actively or consciously push for tax avoidance but, rather, induce corporate management to focus on bottom-line performance. Hoping to fulfill their institutional investors’ financial expectations, portfolio companies will take advantage of more aggressive tax-planning opportunities.¹⁶⁹ In that context, we must remember that poor absolute performance or poor performance relative to peer firms often triggers shareholder engagement.¹⁷⁰

In this scenario, higher tax-avoidance levels are a by-product of shareholder engagement regarding general performance matters.¹⁷¹ From the perspective of institutional investors, taxes are just another line-item expense, and tax minimization is just as good as other corporate strategies

166. See, e.g., Ann Yerger, *Four Takeaways from Proxy Season 2015*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 14, 2015), <https://corpgov.law.harvard.edu/2015/07/14/four-takeaways-from-proxy-season-2015/> [<https://perma.cc/K32H-3BKR>] (“Company-investor engagement on governance topics—and disclosure of these efforts in the proxy statement—continues to grow, jumping from just 6% of S&P 500 companies five years ago to more than half of those companies in 2015.”); see also Sarah Krouse, *At BlackRock, Vanguard and State Street, ‘Engagement’ Has Different Meanings*, WALL ST. J. (Jan. 20, 2018, 7:00 AM), <https://www.wsj.com/articles/at-blackrock-vanguard-and-state-street-engagement-has-different-meanings-1516449600> [<https://perma.cc/SQ3C-TPVM>] (noting that in 2017, BlackRock held 1,603 private engagement sessions with portfolio companies, Vanguard held 954, and State Street Global held over 670).

167. Lisa M. Fairfax, *Mandating Board-Shareholder Engagement?*, 2013 U. ILL. L. REV. 821, 848.

168. See Elhauge, *supra* note 146, at 21.

169. See, e.g., Khan et al., *supra* note 16, at 102 (hypothesizing that “managers ‘deliver’ tax avoidance when institutional ownership increases, rather than that institutional owners explicitly and specifically demand tax avoidance”). Khan and his co-authors showed that tax avoidance is used by management to increase net income margins and meet or beat earnings expectations. *Id.* at 103 (“We find a significant discontinuity in net income to sales margins, and the likelihood of meeting or beating analyst earnings forecast targets (MBE), at the Russell 2000 index threshold.”); see also Chen et al., *supra* note 16, at 286 (“Quasi-indexers may directly communicate with the board and managers a desire for improved overall financial performance, and a focus on improving overall performance can motivate managers to achieve better after-tax performance through lower cash taxes and reported tax expense as well.”). The possibility that pressure to deliver better performance might trigger tax avoidance was also acknowledged by former IRS Commissioner, Mark Everson. I.R.S. News Release, *supra* note 100 (“Particularly in the case of public companies, they are driven to show high after-tax profitability to shareholders in a very competitive and complex economic environment.”).

170. See Elhauge, *supra* note 146, at 22.

171. *Contra* Azar et al., *Anticompetitive Common Ownership*, *supra* note 41, at 1552 (distinguishing between the claim that common ownership leads to higher prices and the argument that common owners “actively and consciously pursue[] an anticompetitive agenda, influence[] managers of portfolio firms to compete less aggressively against each other, or even incite[] collusion”).

designed to achieve financial goals. Nevertheless, note that, even if these investors do not actively aim ex-ante for higher tax-avoidance levels, they can predict (and later observe) that their conduct, driven by their financial performance expectations, will ultimately result in higher levels of avoidance.

Another possibility is that common institutional owners push for improved general tax efficiency. They can do so, for example, by suggesting that the firm's tax liability or ETR is too high or higher than that of peer companies. Information on these financial measures can be obtained and processed easily and inexpensively,¹⁷² especially by mutual-fund managers and their analysts.¹⁷³ In this scenario, unlike the first one, institutional investors prefer portfolio companies to improve performance by minimizing tax liability.

A third possibility is that investors could take a more active approach by endeavoring to revise the tax policies of their portfolio companies. This type of engagement would likely be made secretly or in coded language,¹⁷⁴ and would require the common institutional owners to attain firm-specific knowledge, which can be costly.¹⁷⁵ Because common institutional investors own stakes in many companies and often have limited resources allocated to stewardship activities, they are more likely to use high-level monitoring to improve performance rather than focus on specific tax issues.¹⁷⁶ Nevertheless, anecdotal evidence suggests that institutional investors that hold large stakes do, in fact, advise companies on their tax-avoidance policies.¹⁷⁷

3. Board Composition

As tax issues often make their way into the corporate boardroom, the board of directors can play a crucial role in dictating the tax policy of a

172. See, e.g., Novia X. Chen, Sabrina Chi & Terry Shevlin, A Tale of Two Forecasts: An Analysis of Mandatory and Voluntary Effective Tax Rate Forecasts (Nov. 19, 2020) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3271837 [<https://perma.cc/5NHJ-GTAP>] (explaining that financial statement users can aggregate year-to-date tax expense and pretax income to infer the mandatory ETR forecast). Moreover, voluntary ETR guidance is explicitly presented during earnings calls in the form of tax rates, making it more salient and easier to process.

173. See Thomas Doellman, Fariz Huseynov, Tareque Nasser & Sabuhi Sardarli, Mutual Funds' Aversion to Tax-Avoiding Firms: An Anomaly? 3 n.5 (Mar. 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2956615 [<https://perma.cc/3Q22-HA7G>] (explaining that sophisticated institutional investors are "more capable than an average investor to gather both hard and soft data on factors that they perceive important" and that they "incorporate effective tax rates into their calculation").

174. Eric A. Posner, *Policy Implications of the Common Ownership Debate*, 66 ANTITRUST BULL. 140, 143 (2021).

175. See Doellman et al., *supra* note 136 (manuscript at 11).

176. See, e.g., Bebchuk & Hirst, *supra* note 15, at 2099.

177. Cheng et al., *supra* note 104, at 2.

company.¹⁷⁸ For example, a board can approve different tax strategies, structure the compensation of those responsible within the corporation for tax decisions,¹⁷⁹ and allocate more or fewer resources to the tax-management function.¹⁸⁰ All such actions can affect the level of tax avoidance.

Common institutional owners can influence board members through direct engagement about tax issues, but they can also wield influence by affecting the board's composition. Boards frequently consult with their largest shareholders when selecting candidates, and institutional investors often have a say in whether to put a candidate forward for election.¹⁸¹ In fact, many public companies have recently adapted their director selection-procedures to enhance shareholder influence.¹⁸² Numerous public companies have also adopted a "board skills" matrix, which highlights each director's specific skill-set.¹⁸³ In those circumstances, director candidates may be able to signal their tax orientation. Accordingly, institutional investors can support those candidates who have more tax experience or who are known to take a more aggressive stance when it comes to taxes.¹⁸⁴

4. *A Tax-Transparent Environment*

Greater information-demands on the part of sophisticated institutional investors, particularly during conference calls with shareholders and

178. See Kristina Minnick & Tracy Noga, *Do Corporate Governance Characteristics Influence Tax Management?*, 16 J. CORP. FIN. 703, 704–05 (2010).

179. Rego & Wilson, *supra* note 154, at 781. Moreover, as tax savings are calculable and easy to measure, directors and other tax personnel who have an influence on tax planning can easily demonstrate how their work positively affected the performance of the company. Compensating tax personnel based on their demonstrated capabilities to reduce the company's tax liability should therefore be a relatively easy task.

180. *Id.* at 784; Roman Lanis & Grant Richardson, *The Effect of Board of Director Composition on Corporate Tax Aggressiveness*, 30 J. ACCT. PUB. POL'Y 50, 54–56 (2011).

181. See Azar et al., *Anticompetitive Common Ownership*, *supra* note 41, at 1557; Elhauge, *supra* note 146, at 13, 70 (arguing that "even if index funds did not directly communicate about who should be nominated, management would still have incentives to nominate the sort of candidates for whom index funds are likely to vote," and that all of the Big Three indicate that they utilize the "voting to oppose or support the election of particular board members").

182. See Brian R. Cheffins, *Corporate Governance and Countervailing Power* 3 (Eur. Corp. Governance Inst., Law Working Paper No. 448/2019, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3225801 [<https://perma.cc/75WU-Z8T8>].

183. According to John C. Wilcox, the Chairman of Morrow Sodali: "The BlackRock team wants companies to provide more detailed and qualitative information about board members on their website and in annual meeting materials." John C. Wilcox, *Getting Along with BlackRock*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 6, 2017), <https://corpgov.law.harvard.edu/2017/11/06/getting-along-with-blackrock/> [<https://perma.cc/4BAB-J3EQ>].

184. *Contra* Posner, *supra* note 174, at 143 (arguing that "common owners can select or influence the selection of managers based on their propensity to compete").

analysts, are a driving force behind tax-related disclosure.¹⁸⁵ In fact, a study from 2017 found that “income taxes are mentioned in 82 percent of all conference calls . . . and taxes are often mentioned during every conference call a company holds during the year.”¹⁸⁶ Moreover, an increasing number of public companies now voluntarily provide annual ETR guidance during earnings calls,¹⁸⁷ either as part of the presentation portion of the conference calls or in the subsequent press release.¹⁸⁸

Such publicly available data, whether forward-looking or retrospective, can serve as a channel through which commonly owned companies signal their level of tax avoidance to other companies as well as to their institutional shareholders.¹⁸⁹ On the one hand, information on public companies’ past tax-avoidance levels enables other companies to set a tax benchmark pegged to others’ historical performance.¹⁹⁰ Forward-looking information regarding companies’ expected tax performance, on the other hand, helps companies prospectively align their levels of avoidance, with the added advantage that it precedes the timing of tax-related information in annual statements.¹⁹¹ That type of forward-looking information can also amplify the herding effect and help companies predict and adjust the amount of flooding.

185. Anne C. Ehinger, Joshua A. Lee, Bridget Stomberg & Erin Towery, *Let’s Talk About Tax: The Determinants and Consequences of Income Tax Mentions During Conference Calls*, in PROCEEDINGS, ANNUAL CONFERENCE ON TAXATION AND MINUTES OF THE ANNUAL MEETING OF THE NATIONAL TAX ASSOCIATION (2017) (finding a significant positive correlation between analysts’ coverage and the issuance of voluntary ETR guidance during earning calls and suggesting that management usually considers analysts to be helpful in communicating information to institutional investors).

186. *Id.* at 2.

187. *Id.* at 6–7.

188. See Martin Haas, On Effective Tax Rate (ETR) Guidance and the Value-Relevance of Tax-Related Forecasts 6–7 (Oct. 2013) (unpublished manuscript), <https://ssrn.com/abstract=2367242> [<https://perma.cc/7THV-9HUJ>].

189. See Joel Slemrod, *The Economics of Corporate Tax Selfishness* 26 (Nat’l Bureau of Econ. Rsch., Working Paper No. 10858, 2004), <https://www.nber.org/papers/w10858.pdf> [<https://perma.cc/85JY-KUXF>] (explaining that public disclosure of tax sheltering information may backfire “if it facilitates the benchmarking of corporate tax department performance against the performance of competitors and causes a race to the bottom”). The prediction that common ownership can facilitate coordination through increased disclosure was empirically tested and confirmed in the anticompetitive common ownership context. Park et al., *supra* note 41; Andrea Pawliczek & A. Nicole Skinner, Common Ownership and Voluntary Disclosure (June 8, 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3002075 [<https://perma.cc/5GR2-GY98>]. Both studies show that the relaxed-competition environment under common ownership increases voluntary disclosure as companies are less concerned about conveying proprietary information that might be used by their competitors.

190. See Slemrod, *supra* note 189, at 12–13; Thomas R. Kubick, Daniel P. Lynch, Michael A. Mayberry & Thomas C. Omer, *Product Market Power and Tax Avoidance: Market Leaders, Mimicking Strategies, and Stock Returns*, 90 ACCT. REV. 675, 678 (2015).

191. Haas, *supra* note 188 (manuscript at 8).

5. *Analyst Coverage*

Analysts, who obtain and analyze financial information and provide forecasts for other stakeholders in capital markets, can also potentially affect a company's tax-avoidance level.¹⁹² For example, a cashflow projection can heighten the focus on cashflow and induce management to implement tax-planning strategies to achieve the projected results. In fact, tax advisors often promote such strategies as a method to increase earnings and free up cashflow.¹⁹³

It is generally recognized that institutional investors are analysts' most important clients and that the latter are motivated to fulfill their institutional clients' demands.¹⁹⁴ For example, several studies have shown that analysts have an incentive to issue optimistic forecasts for public companies due to their relationships with institutional clients.¹⁹⁵ Following such optimistic forecasts, portfolio companies would be incentivized to find creative ways to increase their earnings, perhaps through tax avoidance.

The presumption that analysts can influence a public company's tax policies and strategies is supported by the tax law literature.¹⁹⁶ For example, one study showed that companies lowered their projected Cash ETR from the third to the fourth quarter when they would otherwise have fallen short of the analyst's forecast.¹⁹⁷ Researchers also found that the effect of an analyst's forecast on a company's tax payments was more significant for companies with high institutional ownership.¹⁹⁸ Notably, this finding is also consistent with the empirical evidence discussed above,¹⁹⁹ which documented a robust negative correlation between institutional ownership and Cash ETR.

192. Chen et al., *supra* note 172 (manuscript at 6–7) (arguing that anecdotal evidence suggests that analysts issue ETR forecasts based on management ETR guidance). *But see* Brian Bratten, Cristi A. Gleason, Stephannie A. Larocque & Lillian F. Mills, *Forecasting Taxes: New Evidence from Analysts*, 92 ACCT. REV. 1, 5–6 (2017) (documenting that 73.6% of analyst ETR forecasts differ from mandatory company ETR forecasts by more than 0.5%, suggesting that analysts do not rely only on management when forming ETR forecasts).

193. See, e.g., Graham et al., *supra* note 158, at 994; Benjamin C. Ayers, Andrew C. Call & Casey M. Schwab, *Do Analysts' Cash Flow Forecasts Encourage Managers to Improve the Firm's Cash Flows? Evidence from Tax Planning*, 35 CONTEMP. ACCT. RSCH. 767 (2018).

194. Paul A. Wong, *The Influence of Institutional Investors on Analyst Earnings Forecast Properties* (July 2016) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2819139 [<https://perma.cc/EV3M-BFCN>].

195. See, e.g., Amitabh Dugar & Siva Nathan, *The Effect of Investment Banking Relationships on Financial Analysts' Earnings Forecasts and Investment Recommendations*, 12 CONTEMP. ACCT. RSCH. 131 (1995); Jennifer Francis & Donna Philbrick, *Analysts' Decisions as Products of a Multi-Task Environment*, 31 J. ACCT. RSCH. 216 (1993).

196. See Graham et al., *supra* note 158; Ayers et al., *supra* note 193; Chen et al., *supra* note 16.

197. Hanlon & Heitzman, *supra* note 114, at 133.

198. Graham et al., *supra* note 158, at 1017.

199. See Chen et al., *supra* note 16; Khan et al., *supra* note 16.

D. The Aftermath of Flooding

When multiple publicly held companies simultaneously engage in tax avoidance, other public companies are likely to reduce their tax payments as well. The explanation for this relationship is twofold. First, peer firms react to deviations between their tax rates and those of their industry competitors and often mimic the average industry level of avoidance.²⁰⁰ As Avi-Yonah observes, once “some firms adopted aggressive tax strategies and saw their effective global tax rate plunge and their earnings per share increase, management in other firms came under pressure to deliver similar results.”²⁰¹ Moreover, it is common for companies within the same industry to follow each other by employing the same types of tax-planning strategies, such as tax sheltering.²⁰² And this mimicking effect is most discernible among companies that share institutional ownership links.²⁰³

Second, because data regarding IRS audit rates are publicly available and anyone can see the declining audit rate—despite the growing prevalence of tax-avoidance schemes—companies that might otherwise have been hesitant to take aggressive positions may now be emboldened to raise their tax-avoidance levels.²⁰⁴ In fact, there is empirical evidence that managers use data provided by the tax authorities to estimate the probability of a tax audit.²⁰⁵ Companies can also look into trends in government revenues, which can indicate that the IRS failed to substantially raise tax revenues through corporate tax audits.²⁰⁶ Connections with former employees who

200. See, e.g., Kubick et al., *supra* note 190, at 678 (showing that companies use the industry average as the primary benchmark for the level of tax avoidance); Vaughan S. Radcliffe, Crawford Spence, Mitchell Stein & Brett Wilkinson, *Professional Repositioning During Times of Institutional Change: The Case of Tax Practitioners and Changing Moral Boundaries*, 66 ACCT. ORGS. & SOC'Y 45, 52 (2018) (confirming that companies focus their tax positions toward “industry norms”); Andrew Bird, Alexander Edwards & Thomas G. Ruchti, *Taxes and Peer Effects* 8 (Rotman Sch. of Mgmt., Working Paper No. 2714468, 2017), <https://ssrn.com/abstract=2714468> [<https://perma.cc/8G7C-DSLL>] (arguing that peer firms react to negative shocks in the tax-avoidance levels of the focal firm, such as significant reductions in its ETR, by reporting lower ETR as well). A former tax director of a Fortune 100 company confirmed to me, off the record, that employees in tax departments do, indeed, calculate the ETR of other firms in the industry and that the firm’s tax-planning behavior is affected by the results of such comparisons.

201. Reuven S. Avi-Yonah, *Corporate Taxation and Corporate Social Responsibility*, 11 N.Y.U. J.L. & BUS. (SPECIAL ISSUE) 1, 24 (2014).

202. See, e.g., Jennifer L. Brown, *The Spread of Aggressive Corporate Tax Reporting: A Detailed Examination of the Corporate-Owned Life Insurance Shelter*, 86 ACCT. REV. 23 (2011); Jennifer L. Brown & Katharine D. Drake, *Network Ties Among Low-Tax Firms*, 89 ACCT. REV. 483 (2014); Kubick et al., *supra* note 190.

203. See *supra* notes 147–50 and accompanying text.

204. For example, firms can access annual and monthly audit coverage reports released by the IRS or other organizations that publish information on the IRS’s work, such as TRAC reports.

205. See Hoopes et al., *supra* note 47, at 1605, 1608 (claiming that corporations can gauge the extent threat of an IRS audit in various ways).

206. *Id.* at 1608.

currently work for the IRS, as well as informal meetings with IRS officials, can also provide useful insights regarding the enforcement capacity of the agency.²⁰⁷ All such information can signal weaker enforcement capability and incentivize companies to increase their tax-avoidance levels, further embedding the vicious cycle of severe levels of noncompliance and overburdened government resources.

III. PROPOSED POLICY REFORM: THE DOUBLE-TAXATION SANCTION REGIME

In the United States, the growing concentration of common institutional owners reveals a hitherto overlooked problem associated with the distortive effect that these institutional investors exert on their portfolio companies' tax-compliance incentives. When multiple profitable corporations participate in corporate flooding and inundate the IRS with aggressive tax returns, they will fail to pay their dues. By doing so, they shift the tax burden to other taxpayers and impose negative externalities on communities.²⁰⁸ Governments are forced to cope by limiting services or raising taxes, which can exacerbate existing inequalities.²⁰⁹ Given the pervasiveness of common ownership, this problem should sound an alarm for policymakers. Identifying an effective, dynamic response to this problem is a must.

We have seen that a firm's optimal level of tax avoidance depends on its estimation of enforcement probability as well as the expected magnitude of the sanction in the case of an enforcement action.²¹⁰ One solution, of course, would be to increase the IRS's budget, thereby boosting enforcement probability. Another would be to impose higher penalties on tax-avoiding companies. Nonetheless, since aggressive enforcement will not deter avoidance if penalties are too low, and given that the imposition of penalties is contingent on aggressive enforcement, each of the potential solutions

207. *Id.*

208. See, e.g., Dowling, *supra* note 35, at 179 (arguing that corporate tax avoidance is socially irresponsible as it denies governments and states resources that are necessary to fulfill their social obligations); John Christensen & Richard Murphy, *The Social Irresponsibility of Corporate Tax Avoidance: Taking CSR to the Bottom Line*, 47 DEVELOPMENT 37, 37 (2004) (claiming that the payment of taxes is one of the most crucial citizenship duties of corporations because "[t]ax revenues are the lifeblood of the social contract, vital to the development and maintenance of physical infrastructure and to the sustenance of the infrastructure of justice that underpins liberty and the market economy").

209. See *supra* notes 33–34; see also Paul Buchheit, *6 Facts About Corporate Tax Avoidance*, INEQUALITY.ORG (Oct. 1, 2015), <https://inequality.org/research/6-facts-corporate-tax-avoidance> [<https://perma.cc/NR4L-TRRE>] (explaining how tax avoidance by large corporations is tightly linked to inequality as it deprives "people all over America . . . of revenue that should be going to education and infrastructure").

210. See *supra* note 3 and accompanying text.

depends on the other.²¹¹ Thus, although the recent cash infusion into the IRS for the purpose of bolstering enforcement of large corporations²¹² is welcomed—particularly as the IRS enforcement capacity has been depleted for years—the usefulness of this move in stopping the flood is likely to prove limited. I believe a more radical solution is called for.

I propose a double-taxation sanction system, whereby penalties would be imposed not only on the audited company but also on any institutional shareholder that held at least a 5% equity stake in the company at the end of the tax year in question.²¹³ By imposing an additional penalty on institutional shareholders, the potential payoff from tax avoidance behavior, which these investors may exploit, is reduced. Thus, even as a standalone measure, the double-taxation sanction regime has the potential to mitigate the benefits derived from flooding, without solely relying on shoring up enforcement efforts.

In the “lighter” version of this proposal, the institutional investor’s ownership percentage would be multiplied by the penalties imposed on the company in connection with the relevant tax year. For example, if BlackRock held a 5% stake in Apple at the end of 2022, and Apple was later required to pay a penalty of \$1 million for its unpaid taxes for the 2022 tax year, then BlackRock would be required to pay \$50,000 to the IRS.²¹⁴ This penalty would be in addition to any amount Apple was required to pay in connection to the audit.

211. Currently, penalties are levied solely on the tax-avoiding company and often constitute only a small fraction of the unpaid taxes. Thus, unless the penalties are substantially higher than they are today, firms would not be sufficiently deterred. See Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 COLUM. L. REV. 689, 695 (2009); Michael J. Graetz & Louis L. Wilde, *The Economics of Tax Compliance: Fact and Fantasy*, 38 NAT’L TAX J. 355, 358 (1985); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1458–59 (2003).

212. See Rapoport, *supra* note 82.

213. The 5% threshold is consistent with the recent proposal of Goodhart and Lastra who suggest extending shareholder liability to a group of “insiders who have both the information and capacity to influence corporate decision-making.” C.A.E. Goodhart & R.M. Lastra, *Equity Finance: Matching Liability to Power* 29 (Ctr. for Econ. Pol’y Rsch., Discussion Paper No. DP13494, 2019), https://eprints.lse.ac.uk/100058/1/Goodhart_CEPR_DP13494.pdf [<https://perma.cc/NH72-98DR>]. According to their definition, this group includes all shareholders with a 5% equity stake or more in a company. See *id.* at 23–27, 29. Moreover, the 5% threshold also overlaps with sections 13(d) and 13(g) of the Exchange Act and Regulation 13D-G on Beneficial Ownership Reporting, which requires disclosure of an equity stake of more than 5%, making it easier to identify the relevant institutional shareholders on which the sanction is imposed. See 15 U.S.C. § 78m(d), (g). I propose that the equity stake should be calculated using the institution’s year-end ownership percentage and based on the aggregate holdings of the entire investment company. This approach ensures that different funds operated by the same management company will be treated as part of the same set of holdings, similar to the analysis by Posner et al. See Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST L.J. 669 (2017).

214. $\$1,000,000 \times 0.05 = \$50,000$.

Because penalties levied on taxpayers are often minimal,²¹⁵ penalizing institutional investors for only a portion of the penalties might prove toothless and a harsher solution might be necessary. Thus, in the “heavier” version of this proposal, the institutional investor’s ownership percentage would be multiplied by the adjustments to the portfolio company’s tax liability. In the previous example, if the amount of Apple’s tax liability for the 2022 tax year was increased by \$100 million, then BlackRock would have to pay a penalty of \$5 million.²¹⁶

I acknowledge that this proposed policy sits at odds with a fundamental principle of corporate law: the limited liability of shareholders.²¹⁷ But there are ample precedents; courts have been willing to pierce the corporate veil when public policies or other considerations have necessitated such action.²¹⁸ Indeed, courts have imposed liability on shareholders in various circumstances, including contractual obligations,²¹⁹ tort liabilities,²²⁰ and breaches of various statutes (including tax law).²²¹ However, in most cases, courts’ readiness to make such a move is contingent upon a shareholder’s act.²²²

Under this proposal, in contrast, institutional shareholders would be sanctioned by virtue of their holdings, even where no direct link between such investors’ conduct and the portfolio company’s tax-avoidance behavior is established. Viewed in that light, a double-taxation sanction regime would be a bold move,²²³ but I believe this progressive approach is justified on several grounds.

First, I contend that the presumption of liability inherent in the proposed policy is necessary, given the difficulty of pinpointing the exact manner in which investors shape a company’s tax policies. As discussed above, some

215. See *supra* note 211.

216. $\$100,000,000 \times 0.05 = \$5,000,000$.

217. LEN SEALY & SARAH WORTHINGTON, CASES AND MATERIALS IN COMPANY LAW 51 (10th ed. 2013).

218. For a review of the tendency of U.S. courts to respect the features of limited liability and separate corporate personality, see Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991).

219. *Id.* at 1058 (observing that courts had pierced the veil in 42% of cases related to contract law).

220. *Id.* (observing that courts had pierced the veil in 31% of cases related to tort law breaches).

221. *Id.* (observing that courts had pierced the veil in 41% of cases related to statutory policy). Thompson also found that, in cases involving tax law, courts pierced the veil in 31% of the cases. *Id.* at 1061. Several recent cases enabled the IRS to apply the “transferee liability” tool to collect federal income tax liability owed by a corporation from its shareholders. See, e.g., *Kardash v. Comm’r*, 866 F.3d 1249 (11th Cir. 2017).

222. See *Browning-Ferris Indus. of Ill., Inc. v. Ter Maat*, 195 F.3d 953, 955 (7th Cir. 1999) (“[T]he status of being a shareholder does not immunize a person for liability for his, as distinct from the corporation’s, acts.”); see also Nina A. Mendelson, *A Control-Based Approach to Shareholder Liability for Corporate Torts*, 102 COLUM. L. REV. 1203, 1259 (2002).

223. To ratify the double-taxation sanction regime, Congress would have to pass a statute allowing the government to accord relief from institutional shareholders, in addition to the investee company’s tax liability and regardless of the solvency status of the company.

of these causal mechanisms might operate away from the public eye, making it challenging to irrefutably identify clear links between common institutional ownership and tax avoidance. The growing body of empirical evidence regarding the relationship between institutional ownership and tax-avoidance behavior thus calls for a shift in thinking.²²⁴ The need for such a shift is especially profound if we consider the detrimental consequences of corporate flooding: billions of dollars in lost tax revenues that further amplify the already high corporate tax gap—the gap between taxes that are owed by corporations and taxes that are being collected.²²⁵ We must also consider this: the empirical studies that link institutional ownership and tax avoidance refer to periods when the levels of common ownership were increasing rapidly but were not yet as high as they are today—or as high as they are expected to reach in the future.²²⁶ Because implementing new tax strategies can be a lengthy undertaking, the adverse effect of common institutional ownership on tax compliance incentives may turn out to be even greater than we envision. Merely awaiting the results of yet more research may therefore be considered destructive.

As Posner recently noted, we must evaluate the existing studies on the anticompetitive effects of common ownership and avoid simply waiting for more research.²²⁷ Posner expresses the view that “science cannot prove causation but can only infer it by ruling out increasingly remote alternative theoretical hypotheses.”²²⁸ The same logic should apply here. The growing empirical evidence on the positive correlation between common institutional owners and corporate tax avoidance can best be explained by the powerful incentive that these investors provide for their portfolio companies to become more tax-aggressive. And, even if the only thing that institutional investors did was to close their eyes to overly aggressive tax-avoidance behavior—a very unlikely scenario, given the increasing inclination of these investors to more closely monitor their firms—there

224. *Contra* Elhauge, *supra* note 146, at 25 (claiming that, even if one rejected the ample proof regarding causal mechanisms between common ownership and price increases, it should not matter because “definitive proof on causal mechanisms is not necessary to make enforcement proper or desirable”).

225. According to recent estimations, the total annual tax gap in the United States amounts to approximately \$600 billion and is projected to reach approximately \$7 trillion over the next decade. *See* Sarin, *supra* note 33. This equates to 3% of GDP, or all the income taxes paid by the lowest-earning 90% of taxpayers in the United States. *Id.*

226. *See* Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 737 (2019) (“[T]he combined average ownership stake of the Big Three will rise to 27.6% in ten years, and to 33.4% of S&P 500 equity in twenty years. Similar figures hold for the Russell 3000: our estimation indicates that the average combined stake of the Big Three would rise to 23.9% for the equity of Russell 3000 companies in 2028, and to 30.1% of Russell 3000 companies in 2038.”).

227. Posner, *supra* note 174, at 142.

228. *Id.*

may well be a public policy interest in sanctioning institutional shareholders.²²⁹

Second, institutional shareholders with a 5% or more equity stake in a company will often be its largest shareholders. The likelihood (and profitability) of monitoring through engagement and better stewardship are relatively high with respect to companies in which an institutional investor is one of the most dominant shareholders.²³⁰ In fact, the institutional investors themselves admit that they engage more profoundly with companies that represent a larger portion of their assets under management.²³¹ Accordingly, the tax behavior of public companies whose largest shareholders are institutional investors is likely to reflect the preferences of these dominant shareholders. Moreover, the conventional wisdom in corporate law holds that institutional ownership is associated with strong corporate governance, which better aligns the incentives of managers with those of shareholders.²³² Thus, the tax-avoidance behavior of companies with high institutional ownership is assumed to mirror the preferences of their largest institutional shareholders.²³³ And the evidence demonstrates that those shareholders prefer corporate behavior that results in more tax avoidance. I contend that it is, therefore, reasonable to hold those same powerful shareholders to account for the consequences of those preferences.

At least two economists have recently expressed a somewhat similar approach regarding the need to impose shareholder liability in relation to corporate misconduct on all shareholders who “hold power.”²³⁴ In their 2019 article, Charles Goodhart and Rosa Lastra assert that “insiders who have both the information and capacity to influence corporate decision-making” should be viewed as holding power.²³⁵ They also propose that this

229. According to Khan et al., the fact that certain institutional investors stayed silent even when prompted by the media for their comments on tax inverts in their investment portfolio implies some tacit approval on their part. See Khan et al., *supra* note 16, at 102.

230. See *supra* note 152.

231. *Supra* note 152.

232. See, e.g., Black, *supra* note 60, at 815 (“The case for institutional oversight, broadly speaking, is that product, capital, labor, and corporate control market constraints on managerial discretion are imperfect, corporate managers need to be watched by someone, and the institutions are the only watchers available.”); Audra L. Boone & Joshua T. White, *The Effect of Institutional Ownership on Firm Transparency and Information Production*, 117 J. FIN. ECON. 508, 529 (2015) (“[Q]uasi-indexers demand greater firm transparency and information production to minimize trading and monitoring costs[,] and . . . managers and analysts respond to these requests.”).

233. See, e.g., Andrew M. Bauer, *Tax Avoidance and the Implications of Weak Internal Controls*, 33 CONTEMP. ACCT. RSCH. 449 (2016).

234. See Goodhart & Lastra, *supra* note 213.

235. *Id.* at 29.

category of shareholders should encompass all shareholders with a 5% equity stake or more.²³⁶

Third, imposing liability on large and powerful institutional investors can also be consistent with the purpose of the “controlling persons” provisions under securities laws and regulations.²³⁷ According to these provisions, controlling persons should be held liable jointly and severally for securities violations, along with the controlled company, unless the controlling person establishes one of the defenses provided for under the law.²³⁸ The legislative history surrounding those rules indicates that Congress intentionally refrained from specifying the criteria for determining who qualifies as a controlling person.²³⁹ The rationale underlying such abstention was the idea that the term should have broad and flexible coverage, including circumstances that could not be foreseen at the time of the enactment.²⁴⁰

A new circumstance has, indeed, arisen. The huge concentration of corporate ownership among institutional investors in the United States calls for a reassessment of the conditions under which shareholder liability should be imposed in connection with corporate misconduct, even outside the area of securities compliance. Powerful institutional investors have ready access to information and a demonstrated capacity to influence corporate affairs. In fact, commentators now increasingly recognize that large institutional investors such as the Big Three assume regulatory functions with respect to their portfolio companies.²⁴¹ The underlying notion is that, due to their size and “universal ownership,” these investors have the ability to adopt market-wide standards governing firm conduct and

236. *Id.* at 23. The authors also discuss the possibility that shareholders, particularly institutional shareholders, that hold 2%–5% of the company’s shares would be able to choose whether to count as an ‘outsider’ or as an ‘insider.’ *Id.* at 23. Another alternative is for institutional investors that cross the threshold to be given an opportunity to dispute the assumption of liability. *Id.* at 24. Moreover, suppose the portfolio company has a controlling owner-manager that holds a control block of either common shares or vote-controlling shares in a dual-class structure. In that case, this may constitute a cause to exempt institutional investors with a 5% or more equity stake from liability.

237. 15 U.S.C. § 78t(a); 15 U.S.C. § 77o.

238. 15 U.S.C. § 77o. For an interesting overview of the controlling-persons provisions, see Ralph C. Ferrara & Diane Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007 (1983).

239. See Loftus C. Carson, II, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 NOTRE DAME L. REV. 263, 274 (1997).

240. *Id.* at 274 n.54 (“[C]ontrol’ is not defined in sections 15 and 20(a). This declination was intentional. Congress announced that ‘[i]t was thought undesirable to attempt to define the term. It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted.’” (quoting H.R. REP. NO. 73-1383, at 26 (1934))). More recently, Anabtawi and Stout proposed that a more moderate definition of “control” be adopted. For example, they suggest that shareholders that are capable of using public campaigns or persuasive pressure to affect corporate business decisions should also, under certain circumstances, be viewed as controllers. See Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008).

241. See Dorothy S. Lund, *Asset Managers as Regulators*, 171 U. PA. L. REV. 77, 82 (2023).

compliance.²⁴² Viewed in this light, shareholder regulation—for example, in the form of holding powerful shareholders accountable for the noncompliant behavior of their portfolio companies—is now a core necessity.

Moreover, under Delaware law, a shareholder does not necessarily need to have a majority of votes to qualify as a controlling shareholder.²⁴³ A minority shareholder, or a group of minority shareholders, can be considered a controlling shareholder if they have “effective control” or “outsized influence” on the board.²⁴⁴ Thus, if a group of large mutual funds has exercised a significant influence on a company, whether directly or indirectly, such behavior might be scrutinized under the Delaware law controlling shareholder doctrine.²⁴⁵

The double-taxation sanction regime I propose here offers several significant advantages, chief among which is the increased exposure of institutional investors to tax-audit risk. The across-the-board aggressive tax behavior of public corporations, and the lax enforcement environment it creates, benefit common institutional investors. This dynamic enables them to capture amplified earnings in their capacity as diversified shareholders while exposing themselves to a very minimal downside tax risk. Indeed, the only risk that institutional shareholders bear is the possibility that their portfolio companies will be subject to tax audits in the future and be required to pay additional amounts. From the perspective of such investors, however, this risk is negligible, both because the enforcement probability is reduced under the flooding effect and because they are highly diversified and can more easily diversify away tax risks.²⁴⁶

Given the current state of affairs, common institutional investors unquestionably suffer from a moral-hazard problem, which could be solved by extending shareholder liability.²⁴⁷ As Hansmann and Kraakman explain,

242. *Id.*

243. See Note, *Controller Confusion: Realigning Controlling Stockholders and Controlled Boards*, 133 HARV. L. REV. 1706, 1707–09 (2020).

244. See, e.g., Ann M. Lipton, *After Corwin: Down the Controlling Shareholder Rabbit Hole*, 72 VAND. L. REV. 1977, 1990 (2019).

245. Such a prospect would seem particularly realistic once the voting power of index funds grows, as is expected. See Bebchuk & Hirst, *supra* note 226, at 724 (“Assuming that past trends continue, we estimate that the share of votes that the Big Three would cast at S&P 500 companies could well reach about 34% of votes in the next decade, and about 41% of votes in two decades.”).

246. This is because of their highly diversified portfolios, as suggested by modern portfolio theory. See *supra* notes 32, 74, and accompanying text. Moreover, even if a tax audit is initiated, the taxes that a company would have to pay following the audit should have been borne anyway. Thus, the repayment of such taxes is not an actual economic loss when compared to the alternative of not avoiding taxes in the first place.

247. Cf. Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387 (1992) (discussing the implications of unlimited liability and analyzing

extending shareholder liability helps prevent cost externalization by reducing the desirability of actions that create value for shareholders but negative net present value for society at large.²⁴⁸ A double-taxation sanction regime could therefore readjust the incentive of institutional investors to reduce instances of tax avoidance to pre-flooding levels.

Notably, such a regime could accomplish this result regardless of whether the increased tax-avoidance levels are simply a by-product of the investors' demand for better performance or they result from a specific focus, on the part of institutional investors, on tax minimization. The system I propose might also encourage institutional investors to integrate tax-compliance issues into their stewardship activities and institute monitoring and alignment mechanisms to prompt portfolio companies to relax their aggressive tax behavior.²⁴⁹

The idea that imposing shareholder liability may be useful in combating flooding is also consistent with empirical evidence on shareholder liability in other contexts. For example, several studies have explored the effect of shareholder liability on financial institutions' risk-taking. These studies demonstrated that, once shareholders were personally liable for the consequences of a company's behavior, the latter began to engage in activities that were significantly less risky.²⁵⁰

Another potential upside to the dual-sanction approach I propose is the ability to collect from two entities. This regime constitutes an efficient way to fill government coffers and should thus be appealing to policymakers. Moreover, the ability to impose a penalty on institutional shareholders might incentivize the tax agency to allocate more resources to companies with high levels of institutional ownership. Targeting these companies would make sense, given that they are known to be more tax-aggressive and there is therefore a high likelihood that a tax audit of these companies will

the advantages and shortcomings of this liability structure, while also exploring its compatibility with modern financial systems); Alessandro Romano, Luca Enriques & Jonathan R. Macey, *Extended Shareholder Liability for Systemically Important Financial Institutions*, 69 AM. U. L. REV. 967, 986 (2020) (proposing an extended liability regime for Systemically Important Financial Institutions (SIFIs), and explaining why it is superior to both unlimited and traditional limited liability).

248. See Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1883 (1991). Hansmann and Kraakman focus on risky activities in the context of tort law. However, many of their observations are relevant to the flooding theory as well. A core distinction is that the flooding strategy reflects the ability to impose externalities on society through activities that, normally (in the absence of the flooding effect), would be riskier but that, under flooding, are associated with lower risk. This crucial difference further demonstrates the pressing need for policymakers to address corporate flooding.

249. Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 93–101 (1985) (explaining how the incentive of shareholders to monitor managers correlates with the shareholders' risk exposure, which is dependent on the limited liability rule or lack thereof).

250. See, e.g., Benjamin C. Esty, *The Impact of Contingent Liability on Commercial Bank Risk Taking*, 47 J. FIN. ECON. 189 (1998); Richard S. Grossman, *Double Liability and Bank Risk Taking*, 33 J. MONEY, CREDIT & BANKING 143 (2001).

yield tax deficiencies.²⁵¹ In addition, high common institutional ownership is often concentrated in companies at the top of market indices.²⁵² And these companies are more likely to be market leaders, setting the benchmark for tax avoidance. Devoting greater resources to audits of such companies would likely deter flooding (and aggressive tax behavior, in general) by the company in question while, at the same time, mitigating the herding effect by indirectly influencing the tax behavior of other public companies. Thus, under the double-taxation sanction structure, “specific deterrence” could promote “general deterrence” and encourage compliance.²⁵³

Finally, this dual-sanction regime is also likely to result in a positive change in ownership patterns. This is because it might induce investors to limit their holdings to less than 5%, the proposed threshold for triggering liability. Interestingly, legal scholars and economists such as Posner and Scott Morton have recently proposed limiting institutional investors’ holdings to mitigate the antitrust risks associated with common ownership.²⁵⁴ Other scholars, including Bebchuk and Hirst, have suggested limiting investment funds to no more than 5% equity stakes to prevent large asset managers—which are, in their opinion, weak monitors—from accumulating too much power over corporate America.²⁵⁵ A double-taxation sanction regime could help achieve that same policy goal, thereby alleviating various market distortions associated with the concentrated equity stakes of powerful institutional investors.

CONCLUSION

Despite having been overlooked as a mere side effect of the rise in common ownership, corporate flooding has evolved into a significant peril threatening fair corporate governance. The strong and growing presence of large, broadly diversified institutional investors in the U.S. capital markets has helped create a lax enforcement environment that unwittingly rewards noncompliant behavior, resulting in a vicious cycle of abnormal levels of tax avoidance and drained tax revenues.

251. See *supra* Section I.D.

252. See *supra* note 69 and accompanying text.

253. Specific deterrence arises if audited taxpayers become more compliant, while general deterrence is achieved if audits promote compliance among other taxpayers. For an interesting analysis of the two, see Mark C. Stafford & Mark Warr, *A Reconceptualization of General and Specific Deterrence*, 30 J. RSCH. CRIME & DELINQ. 123 (1993).

254. Posner et al., *supra* note 213, at 708 (suggesting that “[n]o institutional investor or individual holding shares of more than a single effective firm in an oligopoly may ultimately own more than 1% the market share unless the entity holding shares is a free-standing fund that commits to being purely passive.”).

255. Bebchuk & Hirst, *supra* note 15, at 2129–31.

A double-taxation sanction regime, as proposed in this Article, represents a promising tool to help break the flooding cycle. Penalizing institutional investors, along with the offending corporate taxpayer, is likely to reinstate deterrence and moderate the distortional effect of common ownership on the compliance incentives of corporate America.

The stakes in the corporate flooding strategy are high. Worryingly, the rationale underlying the theory presented here is equally pertinent to other areas of corporate compliance: common ownership can facilitate the flooding of many other government agencies and impede their day-to-day functioning. My hope, then, is that the present analysis will enable regulators and policymakers to start a conversation around this phenomenon, begin to identify the potentially harmful practices outlined in this Article, and, accordingly, take steps to “stem the flood.”